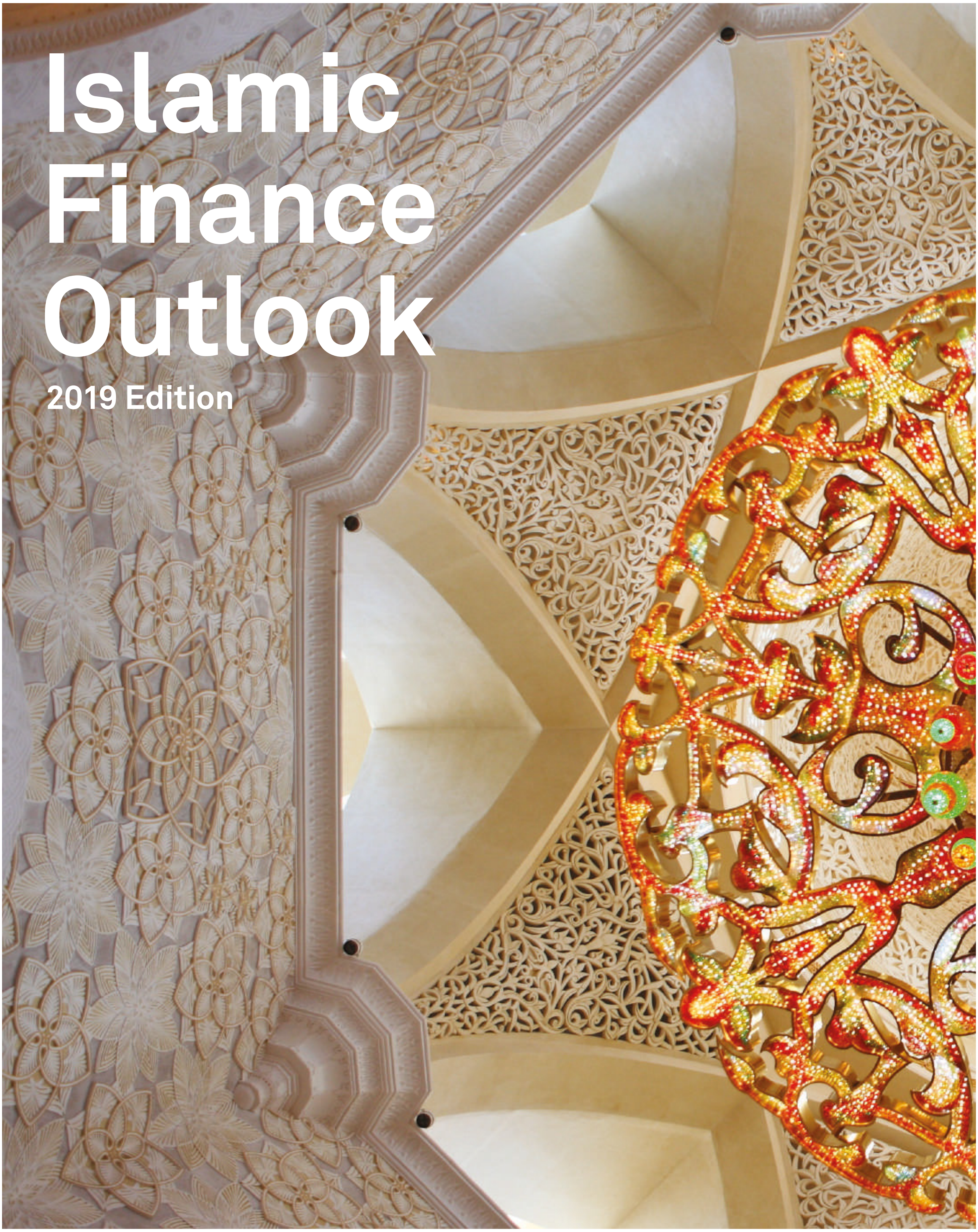
Islamic Finance Outlook

2019 Edition



S&P Global Ratings

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REGULATORY REFORMS AND FINTECH ARE KEY ACCELERATORS

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S&P Global Ratings believes the global Islamic finance industry will expand slowly in 2018 and 2019. It expanded by about 5% in 2017 compared with about 2% the previous year, according to our estimates, with strong support from the sukuk market. Last year, most of the growth stemmed from jumbo sukuk issuances in some Gulf Cooperation Council (GCC) countries. However, sluggish economic conditions in certain core Islamic finance markets weighed on Islamic banking growth, with Malaysia, Indonesia, and Turkey being the main exceptions. Since we anticipate only a mild economic recovery in the GCC, and it is uncertain how the sukuk market will perform in 2018, we believe a low single-digit growth rate over the next two years is a fair assumption.

We see three main opportunities that could unlock the full potential of Islamic finance. These are:

1- **Regulatory reforms:** The world is moving toward profit and loss sharing through recovery and resolution regime implementation. This is an embedded feature of Islamic finance and yet it proves to be challenging to implement on a large scale. The industry can benefit from a dual system. One where transactions can largely mirror characteristics of conventional finance and one with pure profit and loss sharing. In the first system, Murabaha Profit Sharing Investment Accounts (PSIAs) and sukuk with contractual obligations from their sponsor will lead the growth. In the second one, investors in Mudaraba PSIAs and sukuk with loss absorbing features would receive higher remuneration for their higher risks. This will pave the way for the implementation of resolution regimes in jurisdictions where Islamic finance is an important component of the financial system.

2- **Standardization:** In 2017, the market saw a windfall of sukuk issuance as issuers had time on their side. At the same time, cases like the Dana Gas issue acted as a wakeup call for the industry and shifted the attention back on the standardization debate. Investors tend to shy away from the uncertainty they are not able to quantify. Therefore, we think that standardization, of legal documentation and Sharia interpretation, is not only important but is the way forward for the industry to restore its appeal.

3- **Fintech:** We see Fintech as both a potential threat and an opportunity for the Islamic finance industry. It is a potential threat to some business lines such as money transfer, especially in the GCC region where expatriates send more than $100 billion every year back home. Fintech can also unlock new avenues for growth and enhance the security of transactions. Crowdfunding is a potential source of growth especially for SME financings and other risky exposures where banks might not necessarily have the appetite to tap. Blockchain technology can help banks conduct their operations in a more secure way. Finally, regulatory and Sharia compliance can benefit from the Regtech industry.

Thanks to its key principles, Islamic finance can contribute to shared prosperity and growth that is more inclusive. However, to enhance this contribution, the industry needs strong and decisive reforms. Almost 50 years ago, the promoters of Islamic finance have succeeded in unearthing a new industry and, in our view; it is now the responsibility of all the stakeholders to ensure that the industry can reach its full potential.

We hope you enjoy the 2019 edition of our "**Islamic Finance Outlook**," and as always, we welcome and encourage your feedback about our research and insights.

التمويل الإسلامي للعام 2019: الإصلاحات التنظيمية والتكنولوجيا المالية محفزان رئيسيان للنمو

د. محمد دمق

مدير أول والرئيس العالمي للتمويل الإسلامي

تعتقد وكالة "إس آند بي جلوبال للتصنيفات الائتمانية" أن قطاع التمويل الإسلامي العالمي سينمو بوتيرة بطيئة في العامين 2018 و2019. ووفقاً لتقديراتنا فقد بلغت نسبة نمو القطاع حوالي 5% في العام 2017 مقارنةً بنحو 2% في العام 2016، بدعم قوي من سوق الصكوك. وكان معظم النمو الذي شهده القطاع العام الماضي ناتجاً عن الإصدارات الكبيرة للصكوك في بعض دول مجلس التعاون الخليجي. ولكن تراجع الظروف الاقتصادية في بعض الأسواق الرئيسية للتمويل الإسلامي أثر على نمو قطاع الصيرفة الإسلامية، باستثناء بعض الدول على رأسها ماليزيا وأندونيسيا وتركيا. ونظراً إلى أننا نتوقع انتعاشاً اقتصادياً معتدلاً في منطقة الخليج، ولأنه من غير الواضح كيف سيكون أداء سوق الصكوك في العام 2018، نعتقد بأن معدل نمو القطاع سيكون منخفضاً خلال العامين المقبلين.

نرى بأن هناك ثلاثة عوامل رئيسية تُمكن قطاع التمويل الإسلامي من تحقيق أقصى إمكاناته وهي:

1- **الإصلاحات التنظيمية:** يتجه العالم نحو تطبيق مبدأ تقاسم الربح والخسارة من خلال تطبيق نظام استعادة الجدارة الائتمانية وتصفية البنوك. وهذا المبدأ يعد من المبادئ الأساسية في التمويل الإسلامي ولو أنه هناك تحديات تواجه تطبيقه على نطاق واسع. فالقطاع يمكنه الاستفادة من نظام مزدوج. ففي النظام الأول يمكن للمعاملات أن تعكس إلى حد كبير خصائص التمويل التقليدي وفي النظام الثاني يمكن أن يتم تقاسم تام للربح والخسارة. وفي النظام الأول سيقود النمو حسابات الاستثمار المشاركة في الأرباح القائمة على المرابحة والصكوك ذات الالتزامات التعاقدية من الجهة الكفيلة. وفي النظام الثاني سيتلقى المستثمرون في حسابات الاستثمار المتشاركة في الأرباح القائمة على المضاربة إيرادات أكبر على تحملهم لمخاطر أعلى. وهذا سيمهد الطريق لتطبيق أنظمة تصفية البنوك في الدول التي يشكل فيها قطاع التمويل الإسلامي جزءاً هاماً من نظامها المالي.

2- **توحيد المواصفات:** شهد السوق في العام 2017 انتعاشاً في إصدارات الصكوك لأنه كان لدى المُصْدرين وقتاً كافياً للإصدار. وبنفس الوقت، شكلت حالات مثل إصدار دانة غاز جرس إنذار للقطاع وأعادت تسليط الضوء على الجدل الدائر حول توحيد المواصفات. ويميل المستثمرون إلى الابتعاد عن حالة عدم اليقين التي لا يستطيعون تقديرها. وبالتالي، نعتقد بأن توحيد مواصفات الوثائق القانونية وتفسير أحكام الشريعة الإسلامية ليس مهماً فحسب بل هو الطريق أمام هذا القطاع لاستعادة جاذبيته.

3- **التكنولوجيا المالية:** نرى بأن التكنولوجيا المالية تشكل بنفس الوقت مصدر خطر محتمل وفرصة لقطاع التمويل الإسلامي. فهي تشكل تهديداً محتملاً لبعض أنشطة الأعمال كتحويل الأموال، لاسيما في منطقة الخليج التي يرسل منها الوافدون أكثر من 100 مليار دولار أمريكي سنوياً إلى بلدانهم. ويمكن للتكنولوجيا المالية أيضاً فتح آفاق جديدة للنمو وتعزيز أمن المعاملات. كما يمكن أن يكون التمويل الجماعي مصدراً محتملاً للنمو لاسيما لتمويل المؤسسات الصغيرة والمتوسطة والتعرضات الأخرى ذات المخاطر التي قد لا ترغب البنوك بالضرورة التعرض لها. ويمكن لتكنولوجيا سلسلة الكتل مساعدة البنوك في مزاولة عملياتها بطريقة أكثر أماناً. وأخيراً، يمكن للامتثال باللوائح التنظيمية والأحكام الشرعية الاستفادة من صناعة التنكولوجيا التنظيمية.

لتعزيز هذه المساهمة، يحتاج القطاع لإصلاحات قوية وحاسمة. وقد نجح المروجون لقطاع التمويل الإسلامي على مدى خمسين عاماً تقريباً في الكشف عن صناعة جديدة، من وجهة نظرنا؛ والمسؤولية الآن تقع على عاتق جميع أصحاب المصلحة لضمان إمكانية وصول القطاع لأقصى إمكاناته.

نأمل بأن تقضوا وقتاً ممتعاً في مطالعة نسخة العام 2019 من "النظرة المستقبلية السنوية لقطاع التمويل الإسلامي"، ونرحب دائماً بملاحظاتكم على أبحاثنا وآرائنا.

Dubai International Financial Centre

This book is supported by Dubai International Financial Centre (DIFC), in conjunction with S&P Global Islamic Finance Conference in Dubai on 26 September, 2018.

Innovation in Islamic Finance continues to dominate conversations around the sector's future in the Middle East, Africa and South Asia (MEASA) region – a region that is among the fastest growing markets in the world, with a Muslim-dominated population of three billion people and a GDP of USD 7.4 trillion.

As MEASA's leading international financial hub, DIFC is at the forefront of the region's efforts to promote the advancement of the financial services industry. The rise of smart, creative Islamic finance solutions can play a vital role in enabling greater financial inclusion in a region that is home to nearly 50 percent of all financially excluded and underserved individuals.

Islamic finance holds tremendous promise because of the growing demand from both Muslims and non-Muslims who are seeking ethical financial services. The same also applies to Islamic insurance, with huge untapped prospects in the Takaful and Retakaful sectors.

The lack of access to financial institutions and religious non-compliance allows for progressive Islamic solutions to fill the gap in the market.

Promoting innovation in Islamic finance, complemented by regulatory reforms and standardisation efforts, can play a key role in strengthening the sector.

This is an area that DIFC is very committed to contributing to, building on Dubai's growing importance on the global stage as one of the world's top 10 FinTech hubs, and one of the world's top three centres for Islamic finance.

Today, DIFC is home to a world-class FinTech ecosystem that provides a deeply integrated platform for FinTech firms that are willing to create smart solutions and products. This includes the region's first FinTech accelerator, FinTech Hive at DIFC, that will this year broaden the scope of its programme to include InsurTech, RegTech and a focus on Islamic FinTech.

In addition, the Centre's Innovation Testing License and dedicated commercial license for FinTech firms create an environment that is favourable to early-stage and mature financial technology firms. DIFC's ongoing collaboration with the Dubai Islamic Economy Development Centre (DIEDC) and numerous global FinTech hubs is another important catalyst for growth and for further development on the regulatory and structural fronts.

The Future Of Banking: Islamic Finance Needs Standardization And FinTech To Boost Growth

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S&P Global Ratings believes the global Islamic finance industry will expand slowly in 2018 and 2019. We think standardization and financial technology (fintech) could help accelerate the industry's growth in the short to medium term. In particular, standard Sharia interpretation and legal documentation could simplify sukuk issuance, while making room for innovation. Fintech, on the other hand, could stimulate growth by making transactions quicker and easier.

However, fintech could also disrupt the market. In the medium term, we envisage some disruption in the payment services sector, an increase in the number of people using financial services, as well as greater use of regulatory technology (regtech) for Sharia compliance, and blockchain to support transaction traceability and identity protection.

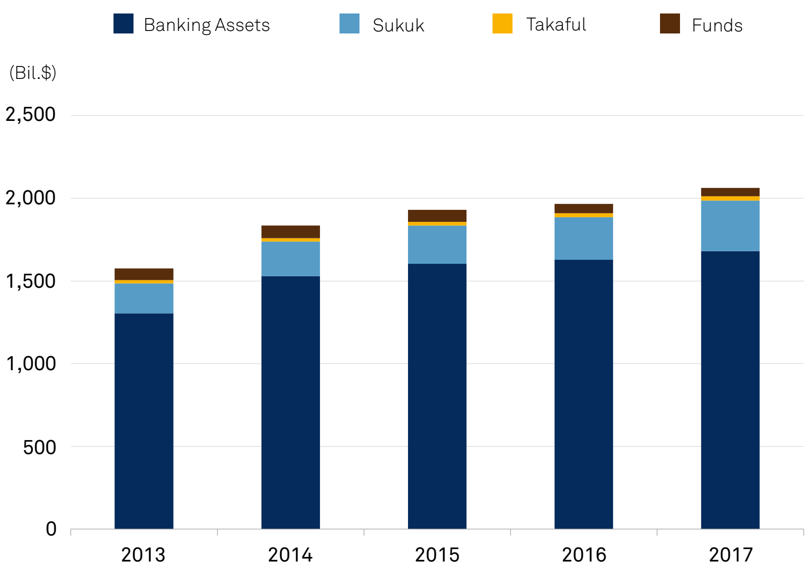
Key Takeaways

- We expect the Islamic finance industry will grow by only about 5% on average over the next two years, owing to tepid economic conditions in certain core markets.
- In our opinion, standardized Sharia interpretation and legal documents would boost the industry's growth by clarifying risks for investors, streamlining the sukuk issuance process, and creating extra scope for innovation.
- While new technology could disrupt the industry, it also has the potential to spur growth, strengthen mechanisms for Sharia compliance, and increase the traceability of transactions through blockchain.

Growth Will Likely Remain Slow Through 2019

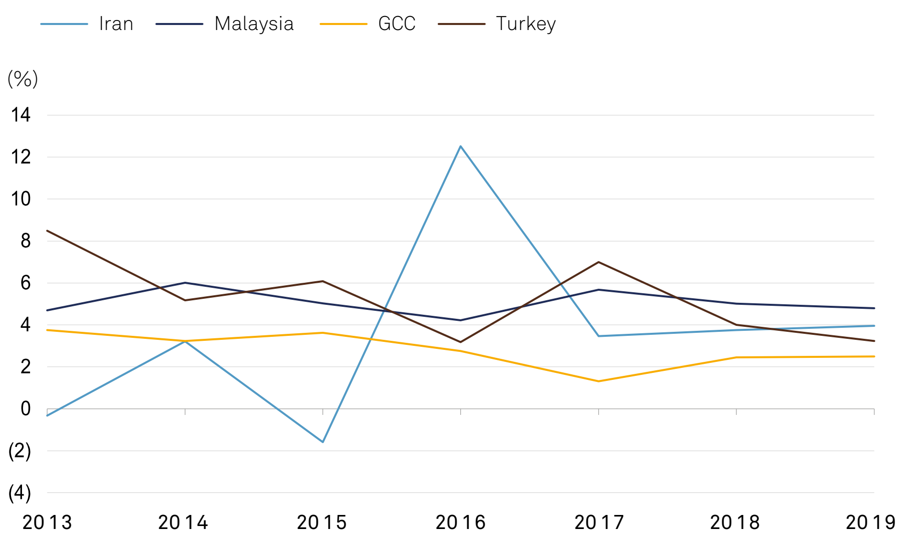
We believe the Islamic finance industry will continue to grow slowly in 2018-2019. It expanded by about 5% in 2017 compared with about 2% the previous year, according to our estimates (see chart 1), with strong support from the sukuk market. Last year, most of the growth stemmed from jumbo sukuk issuances in some Gulf Cooperation Council (GCC) countries. However, sluggish economic conditions in certain core markets weighed on Islamic banking growth, with Malaysia, Indonesia, and Turkey being the main exceptions. Since we anticipate only a mild economic recovery in the GCC (see chart 2), and it's uncertain how the sukuk market will perform in 2018, we believe a low single-digit growth rate over the next two years is a fair assumption. However, we see two factors that could act as accelerators in the medium term: standardization and fintech.

Chart 1 - Global Islamic Finance Assets



Source: Central banks, Eikon, S&P Global Ratings.

Chart 2 - Real GPD Growth In The Main Islamic Finance Markets



Source: S&P Global Ratings and International Monetary Fund.

The First Accelerator: Standardize And The Market's Potential Will Increase

In our view, a prerequisite for faster growth is standardization of Sharia interpretation and legal documentation. This would fuel growth by streamlining the sukuk issuance process, which is still more complex and time consuming than for conventional bonds. That's why some issuers favor the conventional route rather than launch sukuk. Investors are also voicing concerns about the complexity of assessing risk exposure when they invest in sukuk. The recent default of Dana Gas on its sukuk, reportedly due to a lack of Sharia compliance, acted as another wakeup call for the industry.

We see three main trends that will shape the future performance of the sukuk market and Islamic banking.

More stringent application of the profit-and-loss sharing principle

Over the past few years, the debate about the way forward for Islamic finance has resurfaced. Some market participants have expressed the view that the industry was too focused on replicating conventional instruments instead of producing a real benefit through a new way of financing. We believe that a key value-added of the industry lies in reconnecting the financial system with the real economy, and creating a more equitable and responsible financial system. Some countries allow the Islamic finance industry to develop both types of products, or replicas of conventional and specific products. This approach helped develop their Islamic finance industries. Malaysia, for example, authorized banks to offer both Murabaha-based profit-and-loss sharing investment accounts (PSIAs) and Mudaraba-based PSIAs. For the former, depositors bear the risk of the issuer's failure to deliver on its contractual obligations. For the latter, depositors bear the risks related to the underlying assets' performance and value.

Banks' customers and fixed-income investors are accustomed to a certain way of financing their transactions and investing funds. A very strong divergence from this, due to the application of more stringent profit and loss sharing, could push them back to the conventional industry.

Some market participants invest in sukuk because they perceive them as fixed-income instruments. If this perception were to change, the size of investible assets and the investor base would likely change as well, shifting toward equity investors from fixed-income investors. Issuers' cost of funding or the fees users pay for banking services would likely also increase. We can rate sukuk with profit-and-loss sharing features, but the rating is likely to be lower than that on the sponsor. The hybrid issuances that allow for profit deferral and loss absorption at the point of nonviability are good examples.

Scarcity of real assets to back transactions

This is an important impediment that the industry has reported. Our view is different, especially in emerging markets where the government tends to play a significant role in the economy, including as a shareholder. The market has handled this issue relatively well through asset-light structures, where issuers are allowed to combine a certain percentage of tangible assets with commodities to increase the size of their issuance. However, the tangibility ratio varies from one jurisdiction to another. In our view, standardization of this ratio requirement could help institutions plan issuances and use their assets in a more efficient manner.

Insufficient clarity on post-default resolution mechanisms

The recent default of a sukuk has returned the standardization debate to the top of policymakers' agendas. Fixed-income investors tend to shy away from instruments with limited visibility on post-default resolution. Standardized Sharia requirements could prevent potential uncertainty on compliance after a transaction closes, and is therefore key in helping investors better understand the risks involved. Similarly, standard legal documentation provide clarity for investors on the recourse options available in the event of a default of a conventional bond. This is still lacking in Islamic finance. We recognize, however, that the Islamic finance market has achieved a certain level of standardization for the most common structures, while a few new instruments still need some refinements. In particular, investors are asking for additional clarity on the risks attached to the Murabaha-Mudaraba structure that is widely used in some jurisdictions.

The Second Accelerator: Fintech Offers New Avenues For Growth

Market participants typically see fintech as a risk for the financial industry, but we think fintech could also help unlock new growth opportunities through faster execution and better traceability of transactions. According to a recent edition of "IFN Islamic Fintech Landscape," there were around 100 Islamic fintech companies at the end of February 2018 (see chart 3). About 70% of these companies were active in financial services provision (such as money transfer, crowdfunding, and digital banking) and another 30% operate in technical infrastructure (IT, artificial intelligence, and robotics among other things). Around 46% of these companies are based in Asia (see chart 4). Some (for example, crowdfunding companies) are likely to complement the current Islamic banking offer, while others could disrupt the mainstream Islamic finance institutions' businesses.

We believe that fintech could help the industry in several ways:

Ease and speed of transactions

This is particularly true for payment services, money transfer, and infrastructure facilitators. The Islamic finance industry can benefit from the possibilities fintech offers to enhance their services to clients and therefore their attractiveness within the industry or compared with conventional finance. Technology could also reduce costs, allowing redeployment of staff to higher-added-value operations. An interesting example is the recent partnership of Noor Bank and UB QFPay, which together will launch new mobile solutions in the United Arab Emirates for secure payments from Chinese tourists.

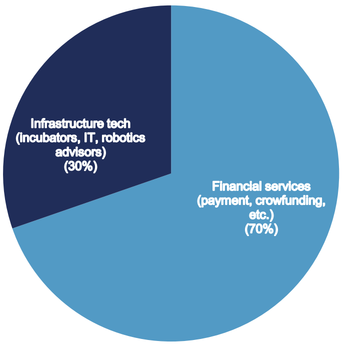
Traceability of transactions

Using blockchain could help reduce the industry's exposure to risks related to transaction security or identity theft. This use of blockchain technology is not unique to Islamic finance. In 2017, some Canadian banks announced similar initiatives in an effort to prevent fraud. Another example of using blockchain to enhance security and traceability of transactions is Emirates Islamic Bank's application of blockchain and quick response (QR) code technologies to reduce fraud. Some of the cheques it issues contain QR codes that are registered in a blockchain.

Greater accessibility of Islamic financial services

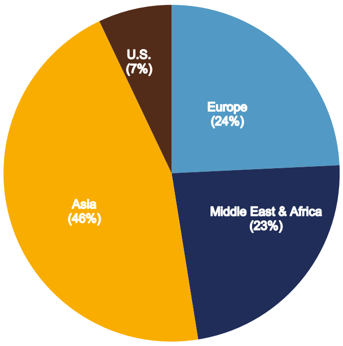
Fintech could also help the industry broaden its reach and tap new customer segments currently excluded from the banking system. For example, mobile banking for clients in remote areas, or provision of products such as crowdfunding for affordable housing or to small and midsize enterprises could provide new growth prospects. Beehive in Dubai or Invoice Wakalah in Pakistan are good examples of crowdfunding at work.

Chart 3 - Islamic Finance FinTech Landscape



Source: IFN Islamic Fintech landscape.

Chart 4 - Islamic Finance FinTech By Geography



Source: IFN Islamic Fintech landscape.

Improved governance

Regtech could affect the Islamic finance industry in a positive manner through more robust tools to achieve compliance with regulations and Sharia requirements, assuming globally agreed Sharia standards are in place. It could minimize the reputation risk related to a potential breach of Sharia requirements, and free up Sharia scholars to focus on innovation.

A prerequisite for fintech's ability to enrich the Islamic finance industry is the implementation of the necessary supervision and regulatory framework. That is why several regulators/authorities in the GCC and elsewhere have launched incubators or specific regulatory sandboxes where fintech companies can test innovations in the real market, but in a restricted regulatory environment. We understand that GCC regulators are looking closely at fintech, not only from the perspective of potential disruption, but also from one of collaboration.

The Impact On Ratings In Islamic Finance

The market's push for more stringent application of the profit-and-loss sharing principle would likely result in lower sukuk ratings than on the sponsors. Sukuk holders' subordination to other creditors, and the issuer's capacity to defer the payment of periodic distributions on sukuk, are factors that we typically consider when notching down from the issuer credit rating to derive the rating on hybrid sukuk.

We foresee only a marginal influence of fintech on our Islamic bank ratings over the next two years. We consider that Islamic banks will be able to adapt to their changing operating environment through a combination of collaboration with fintech companies and cost-reduction measures. We also believe that regulators across the wider Islamic finance landscape will continue to protect the financial stability of their banking systems.

Related Research

- The Future Of Banking: Cryptocurrencies Will Need Some Rules To Change The Game, Feb. 19, 2018.
- Recovery And Resolution Regimes In The Gulf Cooperation Council: More Questions Than Answers, Feb. 11, 2018.
- GCC Banks Should See A More Stable Financial Footing In 2018, Jan. 8, 2018.
- Global Sukuk Market Outlook: Another Strong Performance in 2018?, Jan. , 2018.
- The Future Of Banking: Could Fintech Disrupt Gulf Cooperation Council Banks' Business Models?, Oct. 16, 2017.

Only a rating committee may determine a rating action and this report does not constitute a rating action.

Why the Global Sukuk Market is Stalling in 2018

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The global sukuk market experienced a significant slowdown in issuance in the first half of 2018, as we predicted in January. Total sukuk issuance dropped by 15.3% compared with the same period last year, reaching $44.2 billion compared with $52.2 billion first half of 2017. This drop was even more pronounced for foreign currency sukuk issuance at 45%. We believe that this is due to the absence of major issuances from the Gulf Cooperation Council (GCC) countries seen in 2017.

In the second half of 2018, we expect sukuk issuance volumes will continue to be slowed by the global tightening of liquidity conditions as well as by lower financing needs of some GCC countries as a result of oil prices stabilizing at higher levels. The sharp increase in geopolitical risks in the Middle East will also likely weigh on investors' appetite. Meanwhile, inherent challenges related to the sukuk market continue to drag on expansion of this market. That said, we think that Malaysia will continue to support market growth, owning to its strong market foundations and government support for Islamic finance. Overall, we maintain our expectations for volume of issuance at $70 billion-$80 billion in 2018.

Key Takeaways

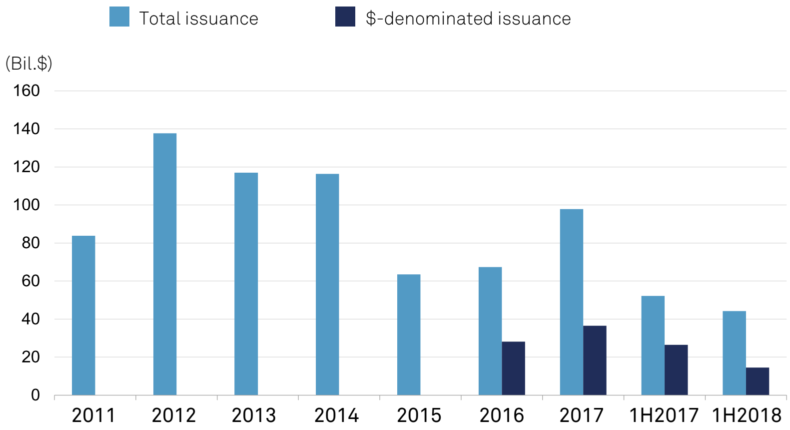
- Global sukuk issuance fell by 15% in the first half of 2018 on the same period of last year.
- The main reason for this is the absence of large issuances from the GCC countries.
- For the full year 2018, we continue to expect sukuk issuance will be subdued, hovering around $70 billion-$80 billion.
- We think sukuk issuance by Malaysia and a few other Asian countries will primarily support the market, and believe some GCC countries will continue to tap the market.

Demand Is Dropping, But Why

Total sukuk issuance in the first half of 2018 dropped sharply compared with the same period in 2017 (see chart 1). The absence of jumbo local and foreign currency issuance by some GCC countries explains this mediocre performance (see chart 2).

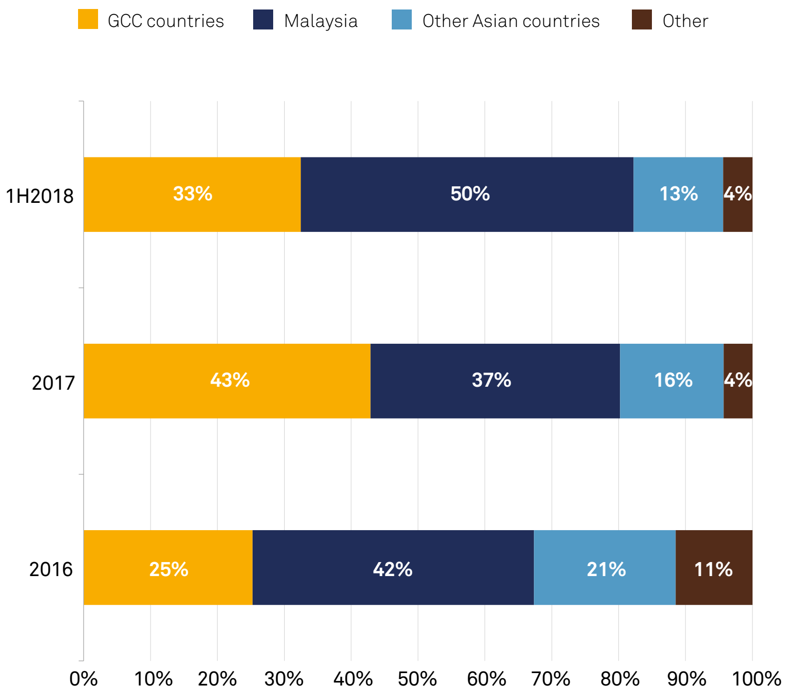
On a positive note, we understand that some of these countries are on the starting blocks with potential issuances in the second half of 2018. However, we expect the overall volume of issuance for 2018 to remain subdued, at around $70 billion-$80 billion, compared with $97.9 billion last year.

Chart 1 - Global Sukak Issuance



Source: S&P Global Ratings, Eikon.

Chart 2 - Sukak Issuance By Region



Source: S&P Global Ratings, Eikon, GCC--Gulf Cooperation Council.

There are four main reasons that we expect the market will continue to lose steam:

Global liquidity is tightening

We expect the tightening of global liquidity that started in the first half of 2018 to continue. Specifically, we expect the U.S. Federal Reserve will hike its federal funds rate by another 50 basis points in the second half of 2018 after the two increases of the first half and that central banks of GCC countries will probably mirror such an increase due to the peg of their currencies with the U.S. dollar. In the same vein, after reducing the pace of asset purchasing (AP), the European Central Bank will likely wind down its AP program in December 2018 and start to raise interest rates in the third quarter of 2019. Overall, we think that the liquidity channeled to the sukuk market from developed markets will reduce and become more expensive. Currently, European and U.S.-based investors account generally for about one-quarter of sukuk investment in terms of volume.

At the same time, muted economic growth and declining lending activity in the GCC has shifted banks' focus to capital market activities in hopes of achieving higher yields than with cash and money market instruments.

Geopolitical risk is flashing red

Over the past 12 months, geopolitical risk have heightened in the eyes of investors. It started with the boycott of Qatar in early June 2017 by a group of Arab states, which we think weakened investors' view of the cohesiveness of the GCC countries as a block. The shifts in Saudi Arabia's power structures and societal norms have also attracted a lot of attention from investors. That said, while increasingly centralized decision-making could lead to more uncertain policy implementation in Saudi Arabia, we don't expect any major deviation from the stated policy course.

Additionally, the recent reinstatement of U.S. sanctions on Iran and the continued animosity between Iran and some of its GCC neighbors are not helping investors' perceptions.

Financing needs are declining in the GCC

We consider that GCC countries' need for financing is reducing as liquidity conditions improve. This is thanks to higher oil prices, which we now expect to remain at about $65 per barrel in 2018, and continued expenditure reduction by GCC countries since 2015. Overall, we think that the gross commercial long-term debt issuance of GCC countries will decline by 15% in 2018 from 2017.

By contrast, the repeal of the good and services tax in Malaysia without sufficient offsetting measures could result in higher fiscal deficit and financing needs for the country. This could further boost its sukuk issuance. In the first half of 2018, total sukuk issuance in Malaysia increased by around 50% compared with the same period last year, underpinned by higher government and corporate issuance.

Standardization is progressing slowly

Standard-setting bodies have made significant efforts to drive forward the standardization of sukuk, but there is still work to be done. Some market participants still think that standardization is unrealistic and that it would be better to aim for harmonization--that is having standards, although these may vary across jurisdictions --and leave some flexibility for implementation. We see this as the status quo. Cases similar to Dana Gas--where the issuer reportedly defaulted on its $700 million sukuk on the basis that the instruments were no longer compliant with Sharia law--will act as regular wake-up calls and bring the standardization debate back on the table.

We continue to see standardization as an important topic and note that fixed-income investors tend to shy away from instruments with limited visibility on post-default resolution. Standardized Sharia requirements could prevent potential uncertainty on compliance after a transaction closes, and is therefore key in helping investors better understand the risks involved. Similarly, standard legal documentation provides clarity for investors on the recourse options available in the event of a default of a conventional bond. This is still lacking in Islamic finance.

We recognize, however, that the Islamic finance market has achieved a certain level of standardization for the most common structures, while a few new instruments still need some refinement. In particular, investors are asking for additional clarity on the risks related to the Murabaha-Mudaraba structure that is widely used in some jurisdictions. We are of the view that standardization for cross-broader sukuk issuance is not only achievable, but will also boost the volume of issuance. It will improve the attractiveness of the instrument to issuers by making the issuance process smoother and faster and by providing more clarity on the underlying risks.

Dana Gas Dispute Highlights Unresolved Issues

The Dana Gas dispute raised several questions about the enforceability of the foreign judgments in the UAE. While the U.K. court ruled in favor of the investors, a local court in Sharjah ruled in favor of the company. Ultimately, in May 2018, Dana Gas reportedly reached a deal outside of court with the creditors committee of its sukuk (that attracted the support of the majority of sukuk holders in their extraordinary general assembly).

While we don't attribute the recent drop in sukuk issuance in the GCC to the Dana Gas case, we do believe that the underlying issue is suppressing investors' appetite for GCC sukuk. Positively, we note that since the dispute there have been a few changes in the legal documentation language for new sukuk issuances, reportedly, to reduce the risk of such disputes occurring. Restructuring of debt is a common practice in the global capital market. However, additional rules and clarity around restructuring or resolution of sukuk is needed for both issuers and investors, in our view. For the Islamic capital market, higher standardization could help in setting these rules and achieving clarity.

Related Research

- Global Sukuk Market Outlook: Another Strong Performance In 2018?, Jan.8, 2018.
- GCC Islamic Banks' Financial Profiles To Stabilize In 2018, April 23, 2018.
- The Future Of Banking: Islamic Finance Needs Standardization And FinTech To Boost Growth, April 16, 2018.
- AAOIFI Proposes Recommendations For Central Sharia Boards: A Step In The Right Direction, Feb. 13, 2017.

Only a rating committee may determine a rating action and this report does not constitute a rating action.

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This presale report is based on information as of Jan. 5, 2018. The ratings shown are preliminary. This report does not constitute a recommendation to buy, hold, or sell securities. Subsequent information may result in the assignment of final ratings that differ from the preliminary ratings. Final ratings will depend upon receipt and satisfactory review of all final transaction documentation, including legal opinions. Accordingly, the preliminary ratings should not be construed as evidence of final ratings. If S&P Global Ratings does not receive final documentation within a reasonable time frame, or if final documentation departs from materials reviewed, S&P Global Ratings reserves the right to withdraw or revise its ratings.

Profile

Proposed U.S. dollar-denominated sukuk assigned preliminary 'BBB-' issue rating.

Transaction Summary

This presale report is based on information dated Jan. 5, 2018, and is posted in conjunction with the proposed sukuk (trust certificates) to be issued by Perusahaan Penerbit SBSN Indonesia III (PPSI III) under its $25 billion program. PPSI III is a fully owned special purpose vehicle of the Republic of Indonesia (foreign currency: BBB-/Stable/A-3) established solely for issuing foreign-currency-denominated Sharia-compliant securities on international markets. Under the transaction documents, PPSI III will issue certificates under a program based on, among other contracts, Master and Supplementary Lease Agreements and a Purchase Undertaking with Indonesia.

Rationale

The preliminary 'BBB-' issue rating on the proposed trust certificates reflects the rating on Indonesia, because the transaction fulfils our conditions for rating sukuk at the same level as the rating on its sponsor (see " Methodology For Rating Sukuk," published Jan. 19, 2015, on RatingsDirect):

- Indonesia will provide sufficient and timely contractual obligations for the repayment of the periodic distribution amounts (under the Master and Supplemental Lease Agreements) and the principal amount (through the Purchase Undertaking);
- Indonesia's obligations are irrevocable and unconditional;
- These obligations will rank pari passu with Indonesia's unsecured, unsubordinated external indebtedness;
- Indonesia will undertake to cover all the costs related to the transaction through the payment of the supplementary lease for the issuer's benefit and a cost undertaking agreement; and
- Although investors may be exposed to residual assets risks under a total loss event scenario, we assess as remote the risks that such a scenario jeopardizes the full and timely repayment of the trust certificates. Our assessment is based on our opinion that the occurrence of the total loss event is remote, given the structure of the underlying Ijara assets made of a portfolio of government real estate assets located in Indonesia. Our view could be subject to revision, including in case the structure of the portfolio of the underlying assets changes.

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

Table 1 - Transaction Details

Transaction Details	
Issuer, Trustee	Perusahaan Penerbit SBSN Indonesia III
Sponsor	Government of Indonesia
Arrangers	Abu Dhabi Islamic Bank, CIMB Investment Bank Bhd., Citigroup Global Market Ltd., Dubai Islamic Bank PJSC, HSBC
Principal paying agent	Government of Indonesia
Delegate	The Bank of New York Mellon
Governing law	Law of the Republic of Indonesia / English Law

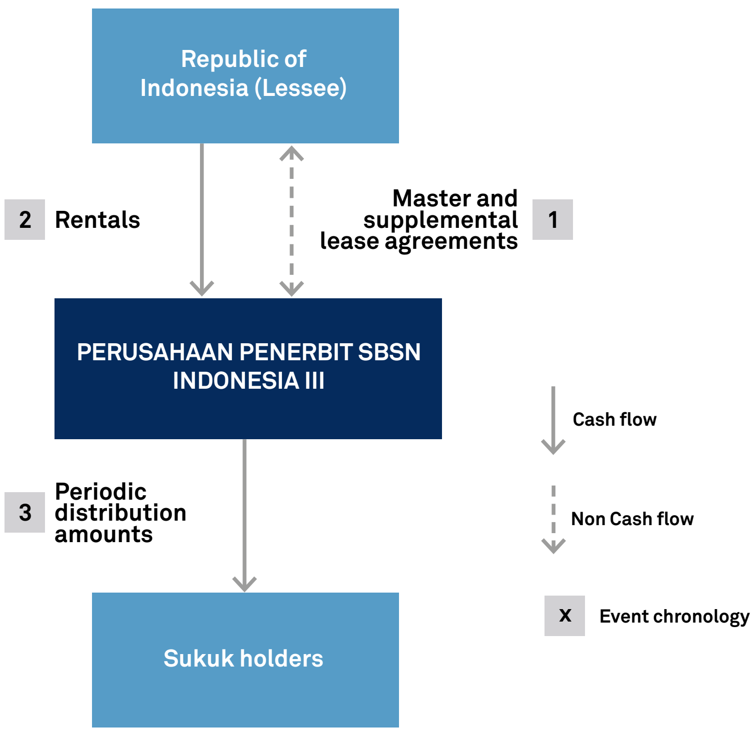
A sukuk that comprises sufficient contractual obligations for full and timely repayment

The transaction involves PPSI III, a legal entity established in Indonesia by the government, solely for the purpose of issuing Sharia-compliant securities in foreign currencies in the international markets. proceeds of the sukuk will ultimately be used for Indonesia's funding purposes. We understand that the issuer will use:

- No less than 51% of the sukuk's proceeds to acquire Ijara assets.
- No more than 49% of the sukuk's proceeds to purchase project assets under a procurement agreement (assets to be constructed) further to which Indonesia will procure the construction of the relevant project assets and deliver such assets upon completion.

Under the master and supplementary lease agreements, PPSI III will lease the Ijara assets to Indonesia against the payment of Ijara asset rentals, whose amount was calibrated to match the amount payable as periodic distribution to sukuk holders. Indonesia's obligations under the master and supplementary lease agreements are unconditional and will rank equally with the the sovereign's unsecured, unsubordinated, and external debt.

Chart 1 - Period Distributions



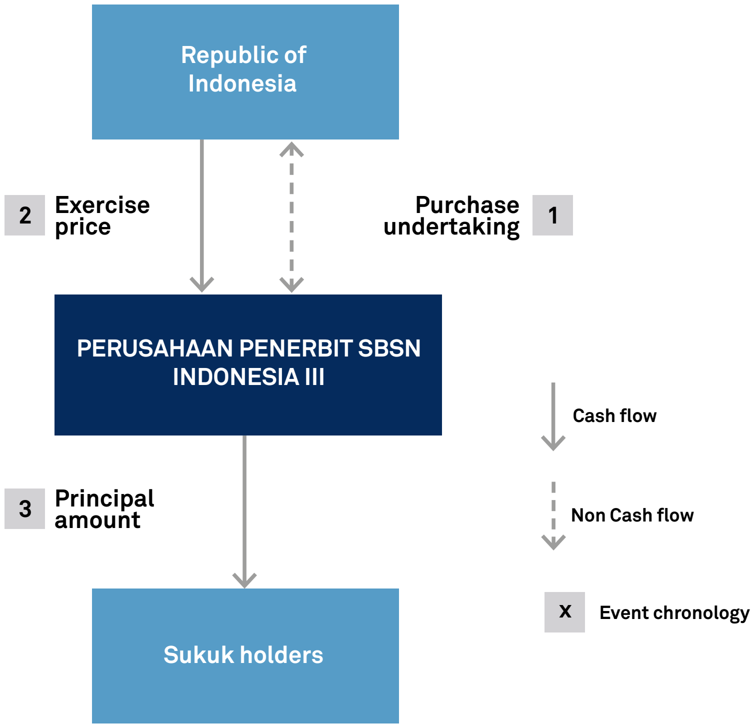
At the maturity date of the transaction or upon the occurrence of an early dissolution event, Indonesia will pay the exercise price under the purchase undertaking. Such price includes the face amount of the sukuk, all accrued but unpaid periodic distribution amounts if any, and any accrued but unpaid supplementary rental. Indonesia's obligations, under the purchase undertaking, are unconditional and will rank equally with the sovereign's other unsecured and unsubordinated external debt.

Indonesia will also cover all the costs related to the transaction arising under the sukuk documentation through a cost undertaking and supplementary rental for the benefit of different participants to the transaction.

Total Loss Event

Although investors may be exposed to residual assets risks under a total loss event scenario, we assess as remote the risks that such a scenario jeopardizes the full and timely repayment of the trust certificates. Our assessment is based on our opinion that the occurrence of the total loss event is remote, given that the structure of the Ijara assets comprises a diversified portfolio of government real estate assets located in Indonesia. Our view could be subject to revision, including if the structure of the portfolio of the underlying assets changes. Furthermore, we see as unlikely that a partial loss event will disrupt the payments to the sukuk holders. Our view is underpinned by the calibration of the rental amount being based on the face amount of the sukuk and not the value of the underlying assets, and that Indonesia has undertaken not to claim to be entitled to pay a lesser amount in any circumstance.

Chart 2 - Principal Repayment



Related Criteria

- Criteria - Governments - Sovereigns: Sovereign Rating Methodology, Dec.18, 2017.
- General Criteria: Methodology For Linking Long - Term And Short -Term Ratings, April 7, 2017.
- General Criteria: Methodology For Rating Sukuk, Jan.19, 2015.
- General Criteria: Use Of Credit Watch And Outlooks, Sept.14, 2009.
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009.

Presale: Sharjah Sukuk Programme Limited

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Profile

Proposed sukuk program assigned preliminary 'BBB+' foreign currency rating.

Transaction Summary

This presale report is based on information dated Jan. 29, 2018, and is posted in conjunction with the proposed sukuk (trust certificates), issued by the Emirate of Sharjah (foreign currency: BBB+/Stable/A-2) via Sharjah Sukuk Programme Limited, a fully owned special-purpose vehicle of the government of Sharjah established solely for issuing Sharia-compliant securities in any currency. Under the transaction documents, Sharjah Sukuk Programme Limited will issue certificates based on, among others, a Master Lease Agreement, a Master Murabaha Agreement, and a Purchase Undertaking.

Rationale

The preliminary 'BBB+' issue rating on the proposed trust certificates reflects the rating on Sharjah, because the transaction fulfils our conditions for rating sukuk at the same level as the rating on its sponsor (see “General Criteria: Methodology For Rating Sukuk,” published Jan. 19, 2015, on RatingsDirect):

- Sharjah will provide sufficient and timely contractual obligations for the repayment of the periodic distribution amounts (under the Master and Supplemental Lease Agreements) and the principal amount (through the Purchase Undertaking and the Deferred Sale Price of the Murabaha Agreement);
- These obligations will rank pari passu with all other outstanding unsecured and unsubordinated obligations;
- Sharjah's obligations are irrevocable and unconditional;
- Sharjah will undertake to cover all the costs related to the transaction through various obligations under different contracts; and
- Investors may be exposed to residual assets risks under a total loss event scenario. However, we assess as remote the risks that such a scenario jeopardizes the full and timely repayment of the trust certificates. Our assessment is based on our expectation that the portfolio of underlying assets will comprise several assets, spread across Sharjah. Our view could be subject to revision, including in case the structure of the portfolio of the underlying assets is different from our expectations.

We therefore equalize our rating on the programme with our foreign and local currency issuer credit rating on Sharjah. The preliminary rating on the trust certificate is based on draft documentation. Should final documentation differ substantially from the draft version, we may revise our rating on the trust certificates. Moreover, we will review the legal documents of each drawdown and if there is a material change in the contractual obligations or our assessment of total loss event risks, the rating assigned may be different from the program rating. This report does not constitute a recommendation to buy, hold, or sell the trust certificates. S&P Global Ratings neither structures sukuk transactions nor provides opinions about the compliance of the transaction with Sharia.

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

The proceeds of the sukuk will ultimately be used for Sharjah's funding purposes.

We understand that the issuer will use:

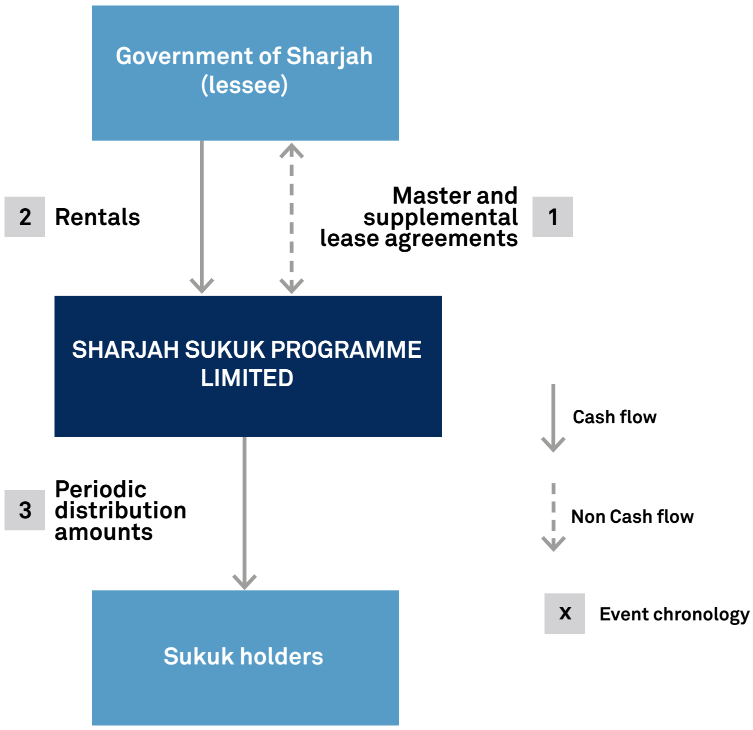
- At least 51% of the sukuk's proceeds to aquire existing Ijara assets under the relevant Supplemental Purchase Agreement.
- No more than 49% of the sukuk's proceeds to purchase commodities pursuant to the Master Murabaha Agreement.

Periodic distribution payments will be based on rental payments under the master and supplemental lease agreements. The total amount of these proceeds will be calibrated to match the amount payable to sukuk holders as the periodic distribution amount. Sharjah's obligations under the master and supplemental lease agreements are unconditional and will rank equally with all other outstanding unsecured and unsubordinated obligations. We understand that the profit amount of the Master Murabaha agreement was added to ensure the Sharia compliance of this contract and will not underpin the distribution to sukuk holders.

Table 1 - Transaction Details

Transaction Details	
Issuer, trustee, purchaser, lessor	Sharjah Sukuk Programme Limited
Sponsor, obligor, seller, lessee, buyer, servicing agent	The Government of the Emirate of Sharjah
Arrangers	HSBC Bank plc
Principal paying agent	Deutsche Bank AG, London Branch
Delegate	Deutsche Trustee Company Limited
Governing law	English Law

Chart 1 - Periodic Distributions Payment



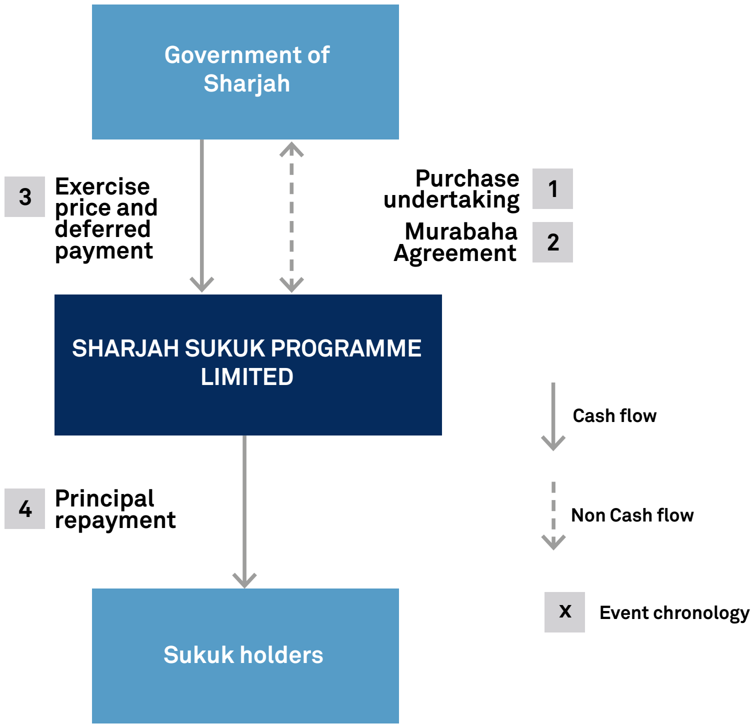
At the maturity date of the transaction or upon the occurrence of an early dissolution event, Sharjah will pay the exercise price under the purchase undertaking. This price includes the face amount of the sukuk, all accrued but unpaid periodic distribution amounts if any, and any expenses payable by the special purpose vehicle under the transaction documents, less the aggregate amount of the deferred sale price, which will be paid under the Murabaha agreement. Sharjah's obligations, under the purchase undertaking and the Murabaha agreement are unconditional and will rank equally with all other outstanding unsecured and unsubordinated obligations.

Sharjah will also cover all the costs related to the transaction through various obligations under different contracts.

Total Loss Event

Although investors may be exposed to residual asset risks under a total loss event scenario, we assess as remote the risks that such a scenario jeopardizes the full and timely repayment of the trust certificates. Our assessment is based on our expectation that the structure of the Ijara assets will comprise a diversified portfolio of government real estate assets located in Sharjah. Our view could be subject to revision, including if the structure of the portfolio of the underlying assets changes. Moreover, under each drawdown, S&P will review the legal documents of each drawdown. If there is a material change in the contractual obligations or our assessment of total loss event risks, the rating assigned may be different from the program rating.

Chart 2 - Principal Repayment



Related Criteria

- Criteria-Governments-Sovereigns: Sovereign Rating Methodology, Dec. 18, 2017.
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017.
- General Criteria: Methodology For Rating Sukuk,Jan.19, 2015.
- General Criteria: Use Of Credit Watch And Outlooks, Sept. 14, 2009.
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009.

Related Research

- Sharjah Sukuk Programme Limited Assigned Preliminary 'BBB+' Rating, Feb.16, 2018.

Presale: Tolkien Funding Sukuk No. 1 PLC

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Class	Prelim rating*	Class size (%)§	Available credit support (%)†	Profit rate	Step-up profit rate	Step-up date	Legal final maturity
Certificates	AAA (sf)	83.33	18.33	Three-month sterling LIBOR plus a margin	Three-month sterling LIBOR plus a margin	April 20, 2021	July 20, 2052

*The rating on the certificates is preliminary as of Jan. 29, 2018, and subject to change at any time. We expect to assign the final credit rating on the closing date subject to a satisfactory review of the transaction documents and legal opinion. Our rating on the certificates addresses timely receipt of profit and ultimate repayment of principal. §Class size is expressed as a percentage of the performing collateral balance at closing. †This is the initial credit support comprising overcollateralization and cash reserve.

Transaction Participants	
Issuer	Tolkien Funding Sukuk No. 1 PLC
Originator, seller, and servicer	Al Rayan Bank PLC
Arranger	Al Rayan Bank PLC
Lead managers	Al Rayan Bank PLC and Standard Chartered Bank
Back-up servicer	Homeloan Management Ltd.
Security trustee and delegate	U.S. Bank Trustees Ltd.
Cash manager, transaction account provider, agent bank, and principal paying agent	Elavon Financial Services DAC (U.K. Branch)
Corporate services provider	Law Debenture Corporate Services Ltd.

Supporting Ratings	
Institution/role	**Ratings**
Elavon Financial Services DAC (U.K. Branch) as transaction account provider*	AA-/Stable/A-1+

*Rating derived from the rating on the parent entity.

Transaction Key Features*	
Closing date	February 2018
Collateral	Home purchase plans structured as Sharia-compliant diminishing musharaka with Ijara, originated by Al Rayan Bank to its retail customers in the U.K.
Principal outstanding of the pool (mil. £)§	300.0
Country of origination	England and Wales
Concentration	South East and London: 55.9%
Property occupancy	Owner-occupied: 100%
Weighted-average indexed current FTV ratio (%)†	59.60
Weighted-average indexed original FTV ratio (%)†	69.16
Average HPP size balance (£)†	180,482
Weighted-average seasoning (months)†	22
Arrears > one month (%)†	0.00
Redemption profile	Repayment 100%
Cash reserve (%)	Static at 2.0% of closing balance of the certificates (see explanation in relevant section below)
Property charge priority	First-ranking

*Data is based on a provisional pool as of Jan. 19, 2018. §Expected performing collateral balance at closing.
†Calculations are according to our methodology. FTV--Finance-to-value. HPP--Home purchase plan.

Transaction Summary

S&P Global Ratings has assigned its preliminary 'AAA (sf)' credit rating to the certificates that **Tolkien Funding Sukuk No. 1 PLC** (Tolkien No. 1; the issuer) will issue.

Our preliminary rating addresses the timely and full payment of profit on the certificates, and ultimate repayment of principal by the final maturity date falling in July 2052.

Tolkien No. 1 is the first securitization originated by Al Rayan Bank PLC (Al Rayan Bank). It securitizes a static pool of home purchase plans (HPPs) originated by Al Rayan Bank to its retail clients in England and Wales. An HPP is a Sharia-compliant form of financing an individual customer for the acquisition of residential property, having a similar, although not identical, economic effect to a conventional mortgage loan. Each HPP contract is governed by English law and is also compliant with Sharia law (for more details on HPPs, see 'Notable Features' below).

On the issue date, Tolkien No. 1 will issue the certificates, acquire the portfolio assets (the eligible pool of HPPs) from Al Rayan Bank, and declare a trust over the portfolio assets for the benefit of the certificateholders. As security for the payments under the certificates, Tolkien No. 1 will enter into the deed of charge with the security trustee, creating security for the certificateholders and other secured creditors. All payments due under the certificates will therefore be secured by cash collections from HPPs distributed in accordance with the contractual payment priority, and will not be guaranteed by any third party. Credit risk of the closing portfolio of HPPs, which is a rather small and untested product in the U.K. residential finance market, is the main risk factor in this transaction.

Al Rayan Bank, which we do not rate, will service the portfolio of HPPs. The back-up servicer, Homeloan Management Ltd. (HML), will be appointed from closing to become a successor servicer if the original servicer is terminated. HML has an above average servicer ranking from S&P Global Ratings, and has gained practical experience in servicing HPP contracts (see "Servicer Evaluation: Computershare Loan Services (HML)," published on Oct. 5, 2017). Given a limited range of potential successor servicers of HPPs, which is a burgeoning and niche product in the U.K., we consider the availability of an experienced back-up servicer an important mitigating factor for the operational risk in this transaction. As to the commingling risk arising from an unrated servicer, we stressed it in our cash flow model.

The transaction will be exposed to the counterparty risk of Elavon Financial Services DAC (U.K. Branch), acting as a transaction account provider. Given that the U.K. branch is not rated, we equalize its rating with that of the parent entity, Elavon Financial Services DAC (AA-/Stable/A-1+), according to our criteria (see "Methodology Applied To Bank Branch-Supported Transactions," published on Oct. 14, 2013). The draft transaction documents contain adequate replacement provisions to support a preliminary 'AAA (sf)' rating on the certificates in line with our counterparty criteria (see "Counterparty Risk Framework Methodology And Assumptions," published on June 25, 2013).

The credit enhancement available to the certificates will comprise overcollateralization, cash reserve and excess spread. The overcollateralization will arise from a positive difference between the performing collateral balance and the certificates' balance at closing, to be recorded as a deferred purchase price and repaid as a junior item in the pre-enforcement principal payment priority. Taking into account our credit and cash flow stresses and the transaction's payment structure, we consider the available credit enhancement for the certificates to be commensurate with the preliminary 'AAA (sf)' rating that we have assigned.

Notable Features

This is the first transaction backed by a pool of HPPs that we have rated.

HPP contracts

HPPs are structured as Sharia-compliant diminishing musharaka. In its broad sense, musharaka is a co-ownership contract where each party provides capital toward the financing of a project or a venture. The eligible HPPs backing this transaction have been provided for the acquisition of freehold or leasehold residential properties in England or Wales. At HPP origination, the customer finances no less than 20% of the appraised property value, and the rest of the acquisition cost is financed by Al Rayan Bank. As long as one party (a customer) makes payments to another to increase its participation in the property, the share of another party (the originator) is diminishing, therefore from the originator's standpoint, the product is called HPP, which is based on diminishing musharaka and Ijara.

Each HPP contract between Al Rayan Bank and a customer consists of four agreements:

- A diminishing co-ownership agreement (musharaka), by which the customer agrees to buy Al Rayan Bank's initial share in the financed property, and to make scheduled monthly acquisition payments resulting in increasing customer share in that property. Once the customer repays the entire finance balance, the property ownership is passed to the customer. Prior to that, the legal title in the property remains with Al Rayan Bank.
- A lease agreement, by which Al Rayan Bank leases the property to the customer, enabling the customer to reside in that property. Monthly rental payments under the lease agreement and monthly acquisition payments under diminishing co-ownership agreement comprise a single monthly payment, which is what the customer pays to Al Rayan Bank. When compared with payments under a conventional mortgage, acquisition payments are analogous to the principal component, and rent payments are analogous to the interest component.
- A service agency agreement, by which Al Rayan Bank appoints a customer as a service agent during the lease term for the property maintenance and other charges in relation to the property, payable at the customer's expense.

- A legal charge, by which the customer charges all its interests in the diminishing co-ownership agreement and the lease agreement to Al Rayan Bank through a separate first fixed charge, as a security for all payments due under the HPP contract.

Each agreement constituting an HPP contact is governed by English law. All four agreements contain a uniform set of representations and undertakings by the customer, and a single set of events of default. A customer's failure to comply with any representation or any payment obligation (be it a rent payment, an acquisition payment, or a property maintenance charge) gives Al Rayan Bank the right to terminate all four agreements in their entirety and sell the underlying property.

HPP transfer to the issuer

At the sale date, Al Rayan Bank will transfer to the issuer all of its rights, titles, interests, and benefits under the HPPs, including the right to receive all remaining payments due by the customers, benefits in insurance contracts in relation to the underlying properties, and beneficial title in the residential properties backing HPP contracts. The legal title to the HPPs and the underlying properties will be retained by Al Rayan Bank on trust for the issuer unless any of the perfection events are triggered.

Compared to conventional U.K. residential mortgage-backed securities (RMBS), in this transaction the issuer will become the beneficial titleholder in the underlying residential properties from the sale date. In our analysis, we relied on the tax opinion confirming that stamp duty land tax should not be applicable to the issuer. In all other respects, the tax analysis is similar to a typical U.K. RMBS. We have therefore not applied any specific tax-related stresses in our cash flow model.

The issuer holding the beneficial title in the underlying properties has not negatively affected our comfort on the assets' true sale, or our analysis of the issuer's bankruptcy remoteness in accordance with our legal criteria (see "Structured Finance: Asset Isolation And Special-Purpose Entity Methodology," published on March 29, 2017).

Enforcement of HPP contracts

Based on the transaction legal opinion, the enforcement process on HPP contracts is fairly similar to the enforcement of a conventional residential mortgage in the U.K. In both cases, a court decision is required before selling the underlying property with vacant possession: in case of a conventional mortgage, to allow the bank possession of the mortgaged property and appoint a receiver, while in case of HPPs, to terminate the lease agreement. The grounds for terminating the lease have been set out in the prevailing housing law of the U.K., and include two outstanding missed monthly rent payments, among other requirements.

As of the portfolio cut-off date, Al Rayan Bank has not experienced any defaults on the HPPs, and therefore has not sought court enforcement of the HPP agreement. Nevertheless, the bank has developed internal procedures to handle the enforcement stage, with the use of its own staff and external legal support, if required. In our analysis, we applied the same assumptions to foreclosure costs and recovery period to the pool of HPPs as for conventional U.K. mortgages, in accordance with our residential loan criteria (see "Methodology And Assumptions: Assessing Pools of European Residential Loans," published on Aug. 4, 2017). While we recognize the untested nature of HPP agreements in the U.K. court practice, we believe that a well-developed legal framework for residential loans would support the servicer through the enforcement process.

Strengths, Concerns, And Mitigating Factors

Strengths

- Al Rayan Bank has a proven record of prudent underwriting procedures, which has kept the actual level of arrears and defaults in the eligible book of HPPs at a very low level over the past 10 years. Since mid-2014 to date, the peak of total arrears was recorded in March 2015 at 1.43%.
- The provisional pool of HPPs has strong characteristics, including no buy-to-let products, no second charges, no customers with county court judgements (CCJs) or bankruptcy records, and no self-certified customers. The weighted-average original finance-to value (OFTV) ratio is 69.2%. The HPP agreements do not allow further advances or redraws on overpayments.
- The transaction has a sequential payout structure and a static reserve. Therefore, the available credit enhancement to the certificates can build up during the transaction's life, enabling it to withstand performance shocks. If a shortfall in revenue collections occurs, principal receipts and the cash reserve can be used to meet timely payment of profit on the certificates.

Concerns and mitigating factors

- HPP is a burgeoning and niche product in the U.K. residential finance market. We assess severity risk (the potential impact of disruption in Al Rayan Bank's servicing to the transaction's cash flows) as moderate, and portability risk (the risk of inability to replace Al Rayan Bank as a servicer) as high in line with our operational risk criteria (see "Global Framework For Assessing Operational Risk In Structured Finance Transactions," published on Oct. 9, 2014). We assess the disruption risk (likelihood of a material disruption in Al Rayan Bank's servicing) as low. Therefore, based on our operational risk criteria, the maximum potential rating on the certificates is 'AA', absent the additional support provided by the back-up servicer. The appointment of HML as an experienced back-up servicer from closing adds two notches to the operational risk cap (up to 'AAA') in our analysis.
- Al Rayan Bank has a limited default history and has not sought enforcement of HPPs in court. Nevertheless, the bank is operationally ready to handle enforcements, and will rely on the U.K.'s well-developed legal framework for residential loans.
- The underlying pool is highly unseasoned, with the weighted-average seasoning of 22 months. Only 3% of

the HPPs in the provisional portfolio receive a seasoning benefit, in accordance with our European residential loans criteria. In addition, to reflect an elevated credit risk stemming from the fast and ongoing portfolio growth, we projected an increase in the level of arrears to 4.55% based on the maximum historical level recorded in our U.K. prime RMBS index since 2010, after the 2008-2009 recessionary period. This increased our weighted-average foreclosure frequency (WAFF) assumptions.

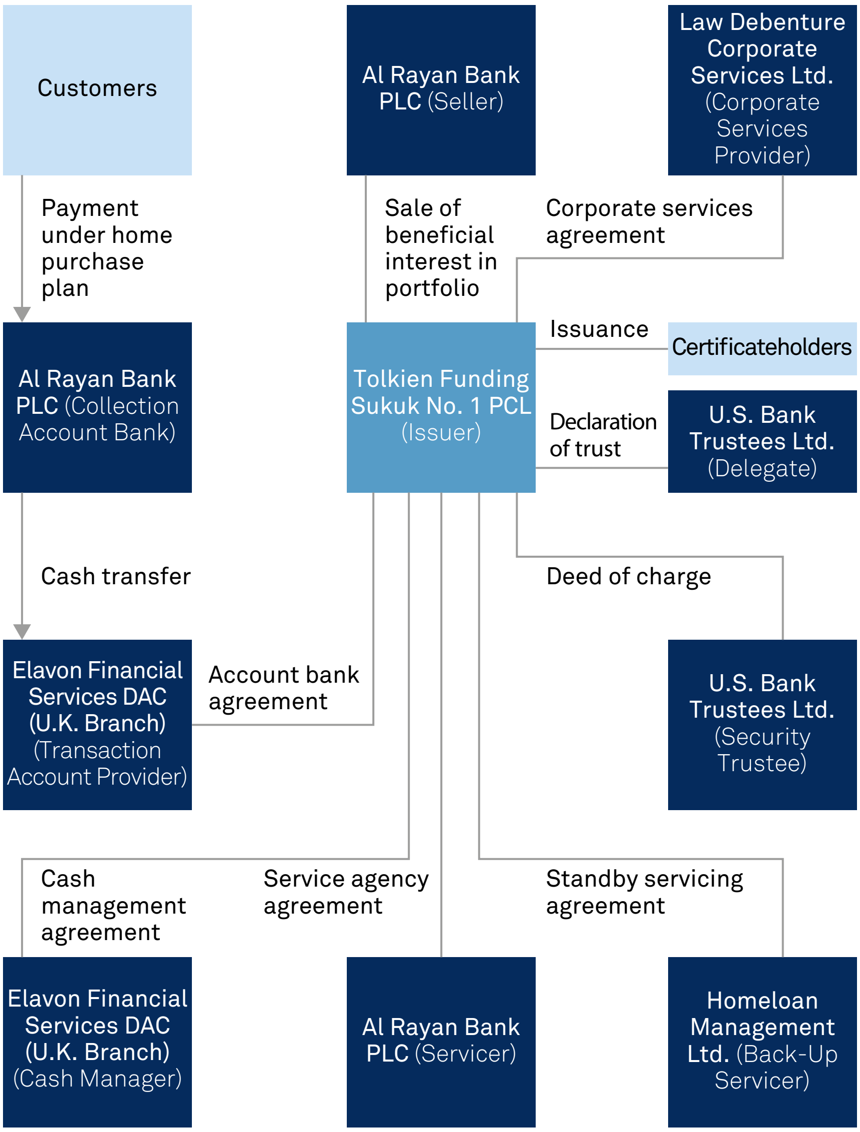
- The issuer, as the beneficial titleholder in the properties, may be liable for property maintenance charges if the customer fails to cover them, leading to an increase in loss severity for the issuer at the end of the recovery process. These expenses would apply only to the leasehold flats in the provisional portfolio. We stressed for these potential charges in our credit analysis.
- The transaction does not hedge the risk arising from the mismatch between the rental rate on HPPs and the profit rate on the certificates. In addition, HPPs in the pool may be subject to a revision in the contractual rental rate at the customers' demand before the step-up date falling in April 2021. We have applied few stress scenarios for pool yield in our cash flow model.
- The transaction will be exposed to a deposit set-off risk, as Al Rayan Bank as the seller is a deposit taking institution. To address this risk, we modelled a set-off loss in our cash flow model.
- There is a commingling risk related to Al Rayan Bank performing as an unrated servicer and collection account bank in this transaction. We stress it as one month of credit loss in our cash flow analysis.

Transaction Structure

At closing, Tolkien No. 1 will issue £250 million of the certificates and use the proceeds to establish a £5 million cash reserve, and invest £245 million to purchase a portfolio of HPPs worth £300 million in outstanding principal balance. Al Rayan Bank will cover the initial costs of issuance.

The certificates will represent an undivided beneficial ownership interest in the closing portfolio of HPPs held on trust for the certificateholders in agreement with a declaration of trust between the issuer and U.S. Bank Trustees Ltd. as delegate. As a security for all payments due under the certificates, the issuer will grant security over all of its assets in favor of U.S. Bank Trustees as the security trustee (see chart 1).

Chart 1 - Transaction Structure



Originator and servicer overview
Al Rayan Bank is a leading Sharia compliant retail bank in the U.K. Sharia-compliant home finance products are a nascent and small segment in the U.K. residential mortgage market, representing only 3% of the total outstanding amount.

Founded in 2004, Al Rayan Bank had a limited scope of operations until 2014, when it started to grow rapidly following a change in controlling shareholder and a capital injection. HPPs remain one of Al Rayan Bank's core products, and the bank aims to further expand this type of financing activities. Underwriting is centralized and is mainly based on affordability tests and customer data verification.

Customer payments are collected through direct debit from bank accounts. Missed payments are handled by the dedicated servicing team in accordance with the arrears management policy.

Al Rayan Bank has a limited arrears history. It recorded no arrears since the beginning of its operations in 2004 until 2012, including over the recessionary period of 2008-2009. Starting from 2012, the bank faced few cases of arrears each year, and all of them have been cleared prior to entering the enforcement stage. Therefore, up until now the bank has had no practical experience in enforcing HPPs. Al Rayan Bank is nevertheless operationally ready to handle enforcements in the future.

We have conducted an onsite review and update calls of Al Rayan Bank's origination and servicing processes as an integral part of our rating analysis. We are satisfied that Al Rayan Bank is capable of performing its functions in this transaction.

Terms And Conditions Of The Certificates

Profit on the certificates
Tolkien No. 1 will pay quarterly profit on the certificates on the 20th day of January, April, July, and October of each year, beginning in July 2018. The profit rate will be equal to three-month sterling LIBOR plus a margin. Following the step-up date (April 2021), the certificates will pay a step-up margin above three-month sterling LIBOR, which we have considered in our analysis.

Mandatory redemption
The certificates will be fully repaid by July 2052, which is the final dissolution date. The issuer will apply available principal receipts to redeem the certificates on each quarterly payment date, subject to the principal priority of payments.

Optional redemption
The issuer may redeem all of the certificates at their outstanding principal balance and accrued profit in the following events:

- In case of an amendment or a change in the tax law, leading to taxes being withheld on the payments under the certificates; or
- On the step-up date or any payment date thereafter following the repurchase of the underlying HPP portfolio by Al Rayan Bank.

In line with the terms and conditions of the certificates, our preliminary rating addresses timely payment of profit and ultimate repayment of principal on the certificates by the legal final maturity. We deem optional redemption events ratings remote because the certificates are to be repaid at outstanding principal and accrued profit in these scenarios.

Collateral Description

As of the cut-off date on Jan. 19, 2018 the provisional HPP pool of £301,428,226.24 comprised 1,672 HPPs secured against properties in England and Wales. The majority of the HPP contracts were originated in 2016 and 2017.

Table 1 - Transaction Key Features

Transaction Key Features	
Portfolio data	
Deal name	Tolkien Funding Sukuk No. 1 PLC
Closing Date	Feb. 9, 2018
Originator	Al Rayan Bank PLC
Country of origination	U.K.
Original balance	£335,372,612.00
Current balance	£301,428,226.24
Property occupancy	100% owner-occupied
Geographich concentration	South East Inc. London (55.81%)
Weighted-average current FTV	59.60%
Weighted-average original fTV	69.16%
Weaighted-average seasoning	2 years
Avgerage time to maturity	24 years
Redemption profile	100% repayment
Income verified/ self certified	0% self-certified
CCJ/IVA/bankruptcy	0%/0%
Employment status	16% self-employed
Specific features	
Rental rate	
Floating rate	3.22%
Fixed rate	2.74%
Weighted-average rental rate	3.17%
Weighted-average rental rate margin	2.67%
Arrears	
30-60	0.00%
60-90	0.00%
90+	0.00%

FTV--Finance-to-value. CCJ--County court judgement. IVA--Individual voluntary arrangements.

Main features of the provisional pool include the following (see table 1):

- None of the customers in the provisional portfolio were subject to CCJs or individual voluntary arrangements, or were subject to bankruptcy proceedings.
- No customers are self-certified.
- The provisional pool comprises approximately 45.3% of HPPs to first-time buyers, which, when unseasoned, are more likely to exhibit a higher historical default probability than otherwise similar contracts.
- The weighted average seasoning is 2 years. As only 3.8% of the provisional pool is more than five years seasoned, we have applied an adjustment to our foreclosure frequency expectation, in line with our European residential loans criteria.
- All HPPs in the provisional pool are repayment type contracts.
- All properties in the provisional pool are owner occupied, and subject to first lien.
- The largest geographical concentration is in South East including London, which represents 55.9% of the total provisional pool. Given that it exceeds the concentration limit set by our European residential loans criteria, we have applied an adjustment to our foreclosure frequency expectation.
- There is a relatively high amount of jumbo valuations in the pool, representing 40.7% of the total, most of them in South East including London, as well as in North West and West Midlands. We have factored these jumbo valuations in our loss severity expectation.

Chart 2 - Seasoning Distribution

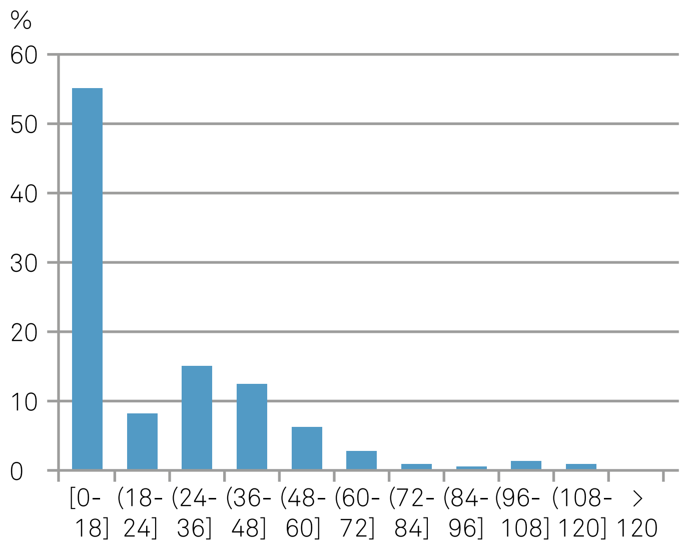
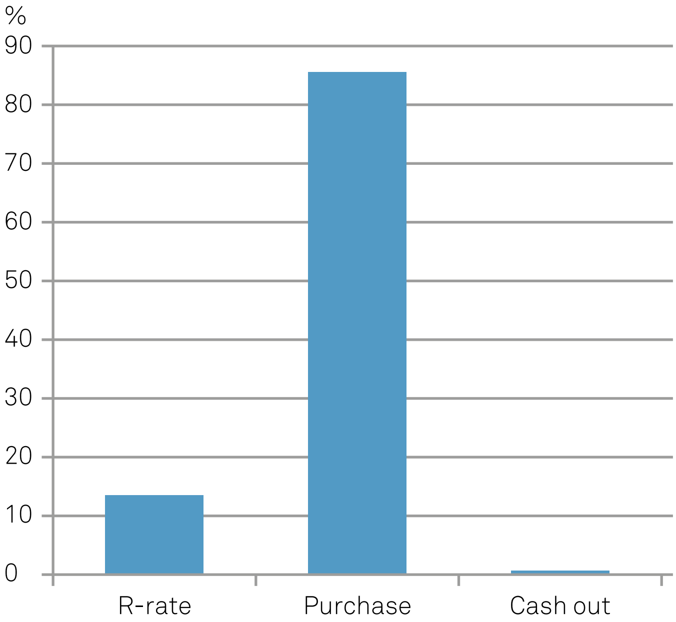


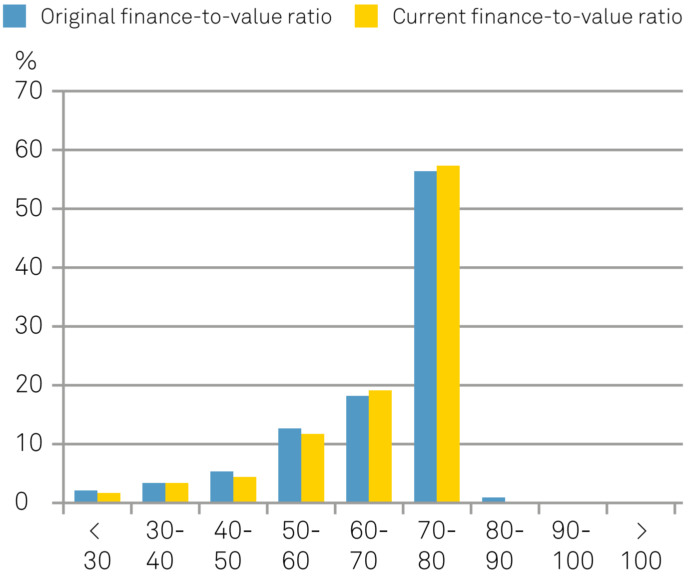
Chart 3 - Portfolio Composition



The provisional collateral pool's weighted-average OFTV ratio is 69.16%--calculated using our European residential loans criteria. We consider that customers with minimal equity in their property are less likely to be able to refinance, and are more likely to default on their obligations, than customers with HPPs that have lower OFTV ratios.

At the same time, HPPs with current indexed high FTV ratios are likely to incur greater loss severities if the customer defaults. The weighted-average indexed current FTV ratio is 59.60%. Of the pool, 0.82% exhibits a current indexed FTV ratio between 80% and 100%.

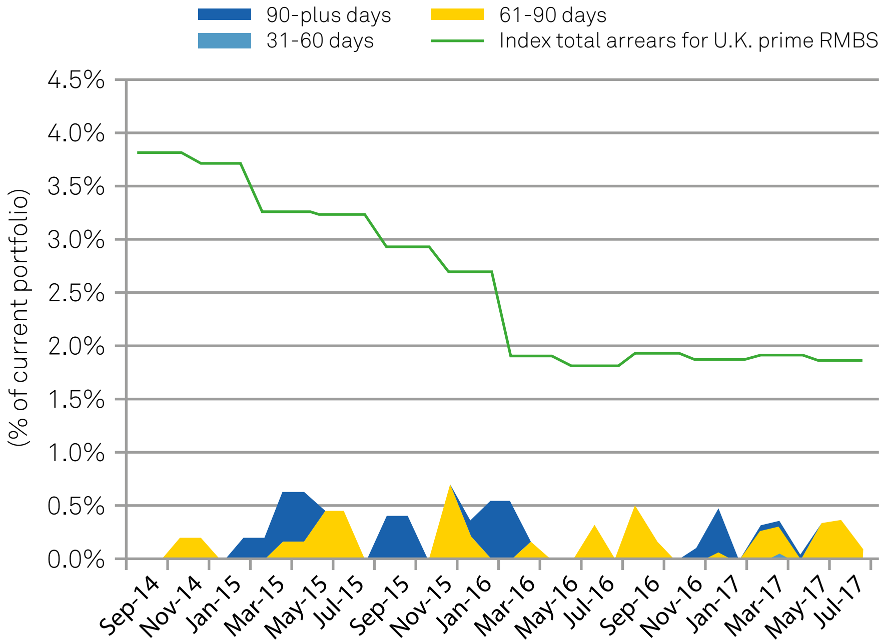
Chart 4 - Current And Original Finance-To-Value Ratio Distribution



Of the provisional portfolio, no HPPs are 30+ days past due arrears. The historical level of arears in the eligible pool of HPPs has been very low (see chart 5).

Chart 5 - Dynamic Arrears

Delinquency performance



In our loss severity calculations, we applied repossession market-value decline (RMVD) assumptions in accordance with our European residential loans criteria, based on the degree of over- or under-valuation for each specific region of the U.K. (see table 2).

Table 2 - Repossession Market Value Declines At The 'AAA', 'AA', 'A', 'BBB' And 'BB' Rating Levels

Repossession Market Value Declines At The 'AAA', 'AA', 'A', 'BBB' And 'BB' Rating Levels						
Region	**AAA (%)**	**AA (%)**	**A (%)**	**BBB (%)**	**BB (%)**	**% of the pool**
East Anglia	63.01	57.51	48.62	42.88	38.47	2.36
East Midlands	58.48	53.65	45.43	40.25	36.30	7.06
North	48.49	45.16	38.39	34.45	31.53	1.41
Northwest England	52.09	48.22	40.93	36.54	33.25	10.90
Northern Ireland	45.70	42.74	36.34	32.72	30.05	0.00
Scotland	44.37	41.43	35.05	31.44	28.78	0.00
Southeast including London	75.00	69.07	58.18	50.76	44.96	55.94
Southwest England	64.12	58.45	49.40	43.52	39.00	2.96
Wales	52.36	48.45	41.12	36.70	33.38	1.33
West Midlands	55.48	51.10	43.32	38.51	34.87	11.56
Yorkshire and Humberside	48.54	45.20	38.42	34.48	31.55	6.47
Weighted-average market value decline	66.09	60.88	51.41	45.18	40.36	

Repurchase of HPPs
The seller will repurchase the affected HPPs if:
- The servicer identifies an HPP that breached the seller's asset warranties on or prior to the sale date, which could have a material adverse effect on the value of the underlying HPP portfolio;
- The seller provides a further advance to a customer;
- The servicer extends the payment terms on any HPP, other than under the recovery or forbearance processes;
- At any time following the step-up date on the certificates (April 2021), the seller changes the original rental rate of an HPP, such as switching the rent rate, extending a fixed-rate period, or extending a discount period; or
- At any time after closing, as a result of switching the original rental rate of the HPPs, the weight of fixed-to-floating rental rate HPPs exceeds 80% of the total current pool balance.

Credit Structure

A combination of overcollateralization, the case reserve, and excess spread provides credit enhancement for the certificates (see table 3).

Table 3 - Final Pool WAFF And WALS

Final Pool WAFF And WALS				
Rating level	**Base FF for an archetypical pool in U.K. (%)**	**WAFF (%)**	**WALS (%)**	**Expected losses (%)**
AAA	12.00	26.40	49.73	13.13
AA	8.00	18.521	40.80	7.56
A	6.00	4.32	26.07	3.73
BBB	4.00	10.20	17.64	1.80
BB	2.00	6.24	12.24	0.76

WAFF--Weighted-average foreclosure frequency.
WALS--Weighted-average loss severity.

Cash collection arrangements and the transaction account
Customers make monthly payments into a collection account held with Al Rayan Bank in its own name. It will take up to two business days for the servicer to reconcile collections and transfer them to the transaction account

held in the issuer's name. The transaction documents will establish a declaration of trust over any amounts in the collection that relate to HPPs purchased by the issuer. We do not rate Al Rayan Bank as a collection account bank or any of its roles in this transaction.

Tolkien No. 1 will open the transaction account in the U.K. branch of Elavon Financial Services. The transaction account will contain five ledgers: the revenue ledger, the principal ledger, the reserve ledger, the principal deficiency ledger, and the trustee profit ledger. Given that we do not rate the U.K. branch, we equalize its rating with that of the parent entity, Elavon Financial Services DAC (AA-/Stable/A-1+), according to our criteria (see "Methodology Applied To Bank Branch-Supported Transactions," published on Oct. 14, 2013).

The draft transaction documents contain adequate replacement provisions on the transaction account bank to support a 'AAA (sf)' preliminary rating on the certificates, in line with our counterparty criteria. Namely, the documents provide that the issuer must take remedial actions, including the replacement of the transaction account provider by a suitably rated financial institution if, at any time, we lower our long-term issuer credit rating on the account bank below 'A/A-1' (or 'A-1+' if no short-term rating is assigned).

In our view, the transaction is exposed to commingling risk arising from the unrated servicer. Given that the collection account bank is not rated, and considering equal distribution of cash collections within a month and one month being sufficient to notify the customers, we sized commingling risk as one month of credit loss in our cash flow model. Commingled amounts include revenue and principal collections and prepayments at a 10% constant prepayment rate (CPR). Our CPR assumption for commingling stress considers limited refinancing options available to HPP customers in the U.K., due to a relatively small number of HPP originators.

Cash reserve
At closing, the proceeds of the sale of the certificates will fund a cash reserve in the amount of £5 million, or 2% of the certificates' balance. The required reserve amount will not amortize. On any payment date, the cash reserve can be used to cover a shortfall in revenue collections to cover senior items of the revenue priority of payments, including senior fees, profit on the certificates, and topping up of the debit balance in the principal deficiency ledger (PDL). On the payment date when the certificates are fully repaid, the outstanding amount of the reserve will be added to the revenue collections and repaid via the revenue priority of payment.

Revenue priority of payments
The revenue collections will comprise the revenue collections on HPPs over the preceding three-month collection period and the amount of cash reserve needed to cover any revenue shortfall on the forthcoming payment date, less any payments received from the customers in error and not previously returned from the collection account.

The revenue priority of payments will be as follows:
- Fees payable to the security trustee and the delegate;
- Remuneration of the cash manager, the agents, the account bank, the corporate services provider, and the standby servicer;
- Trustee profit;
- Servicer fees and Sharia compliance fees;
- Profit on the certificates;
- Amounts to be credit to the PDL until the debit balance is reduced to zero;
- Replenishment of the reserve ledger up to the required amount; and
- Residual revenue to the seller.

Principal priority of payments
The available principal funds will include the principal collections on HPPs over the preceding three-month collection period, and the reduction in the PDL debit balance on the following payment date following the application of the revenue priority of payment.

The pre-enforcement principal priority of payment will be as follows:
- If not paid from the available revenue funds, pari passu and pro-rata, profit on the certificates and fees payable to the security trustee and the delegate;
- If not paid from the available revenue funds, pari passu and pro-rata, remuneration of the cash manager, the agents, the account bank, the corporate services provider, and the standby servicer;
- Redemption of the certificates;
- If not paid from the available revenue funds, servicer fees and Sharia compliance fees; and
- Deferred purchase price payable to the seller.

Principal collections can be used to cover deficiencies in revenue collections only under condition that they were not covered from the available revenue funds, which include the use of the cash reserve.

Principal deficiency ledger
Amounts will be recorded on the PDL if the portfolio suffers

any losses or if the transaction uses principal collections as available revenue receipts.

HPP rental rate
About 21.1% of the provisional pool are floating rental rate HPPs linked to the Bank of England base rate (BBR), 23.0% are floating rental rate HPPs linked to BBR with an initial period of a discounted margin, and the remaining 55.9% are HPPs with the current fixed rental rate convertible into floating rate (BBR plus a margin) at a certain future date. The profit on the certificates is linked to a three-month LIBOR. The transaction structure does not have any hedge in place against the risk of negative carry. We have therefore stressed some additional scenarios in our cash flow model to test the transaction's sensitivity to the assets yield.

The transaction allows Al Rayan Bank to modify the original rental rate on HPPs until the step-up date on the certificates, falling in April 2021. Permitted variations include the extension of the initial fixed or discounted rate period, or the conversion of floating rental rate HPPs into either fixed-to-floating or discounted margin products. The only limit on permitted variations before the step-up date is the seller's obligation to repurchase fixed-to-floating rental rate HPPs, which would result in the share of fixed-to-floating rental rate products exceeding 80% of the current pool balance.

To address the risk that up to 80% of the pool may switch to fixed-to-floating rental rate products, and the remaining 20% may be comprised of discounted margin products before April 2021, we tested this scenario in our cash-flow model.

If Al Rayan Bank is replaced as servicer, the issuer will instruct the stand-by servicer to not offer a contractual floating rental rate but rather a minimum margin of 2.7% over a BBR. We have run a cash flow scenario assuming the entire portfolio will switch to that minimum rental rate.

Set-off risk
The transaction is exposed to a deposit set-off risk as Al Rayan Bank is a deposit-taking financial institution. We stressed a set-off loss in our cash flow model, applicable at closing in the amount of £900,000, based on the historical level of deposits maintained by the customers in excess of the maximum amount covered under the Financial Services Compensation Scheme - currently at £85,000.

Credit And Cash Flow Analysis

We stress the transaction's cash flows to test the credit and liquidity support that the assets and cash reserve provide.

We apply these stresses to the cash flows at a 'AAA' rating level commensurate with the preliminary rating on the certificates. In our 'AAA' stress, all certificates must pay full and timely profit, and full principal by the legal maturity date.

Default and recovery amounts
We have applied the European residential loans criteria in our assessment of the WAFF and the weighted-average loss severity (WALS) for this portfolio. As a starting point in our analysis, we have used the archetypical U.K. residential loan pool assuming benign starting conditions. We have then applied the adjustment factors to each HPP to reflect its characteristics, in accordance with the criteria, to derive its foreclosure frequency, as well as the loss amount upon the property's subsequent sale (the loss severity, expressed as a percentage of the outstanding principal). For the entire pool, we have then determined the WAFF and WALS as summarized in table 3.

Default timings
At each rating level, the WAFF specifies the total balance of HPPs we assume to default over the transaction's life. We model these defaults to occur over a three-year recession. Further, we test the effect of the timing of this recession on the ability to repay the liabilities by starting the recessionary period at closing and year three.

We applied the WAFF to the principal balance outstanding at closing. We model defaults to occur periodically, in amounts calculated as a percentage of the WAFF. The timing of defaults follows two paths, referred to as "front-loaded" and "back-loaded" (according to table 4 in our European residential loans criteria).

Recovery timings
We assume that the issuer regains any recoveries 18 months after a payment default, in line with our standard assumption for owner-occupied properties in the U.K. The value of recoveries at each rating level is 100%, minus the WALS for that rating level (see table 4).

Table 4 - Summary Of Cash Flow Assumptions

Summary Of Cash Flow Assumptions	Certificates
Scenario	AAA
Credit enhancement available (%)	18.33
Expected losses at each rating scenario	13.13
Recoveries (%)	50.27
Recovery lag (months.)	18.00
CPR high (%)	30.00
CPR low (%)	4.00
CPR during recession (%)	3.00
PDL definition	Loss
Actual fees (£)	200
Servicing fee (%)	0.50
Other fees (one-off fee)	357.01
Weighted-average margin (%)	2.67
Weighted-average margin after compression (%)	2.29

CPR--Constant prepayment rate. PLD--Principal deficiency ledger.

We base the WALS that we use in our cash flow model on losses in the finance balance, including foreclosure costs. We do not give credit to the recovery of any rental rate accrued on HPPs during the foreclosure period.

Delinquencies
We model the liquidity stress that results from short-term delinquencies (those HPPs that cease to pay for a period of time, but then recover and become current with respect to both rental rate and finance balance). To simulate the effect of delinquencies, we model a proportion of scheduled collections equal to one-third of the WAFF to be delayed. We apply this in each of the first 18 months of the recession, and model full recovery of these delinquencies to occur 36 months after they arise. Therefore, if the total scheduled collateral collections expected to be received is £1 million and the WAFF is 30% in month five of the recession, £100,000 (one-third of the WAFF) is delayed until month 41.

Profit and prepayment rates
We model four different profit rate scenarios on the certificates — up, down, up-down, and down-up.

We model three prepayment scenarios at all rating levels—high, low, and forecast. For this transaction, we modeled the forecast constant payment rate as 3.4%. During the recessionary period, we model the prepayment rate at 3.0%, before gradually reverting to a high prepayment rate under both scenarios. At the 'AA' level and above, we model an additional low prepayment scenario, which also reverts to a low prepayment rate after the recession period.

In combination, the default timings, recession timings, profit rates, and prepayment rates described above give rise to 60 different scenarios at a 'AAA' rating level (see table 5). The preliminary rating we assign means that the certificates have all paid timely profit and ultimate principal under each of the scenarios at the assigned rating level.

Table 5 - Transaction Stress Scenarios

Transaction Stress Scenarios					
Rating level	**Total number of scenarios**	**Prepayment rate**	**Recession start**	**Profit rate**	**Default timing**
'AAA'	60	High, expected, and low	Closing and year 3	Up, down, up-down, down-up, forward for standard run	Front-loaded and back-loaded
'AA-' and below	40	High and low	Closing and year 3	Up, down, up-down, down-up, forward for standard run	Front-loaded and back-loaded

Scenario Analysis

Various factors could lead us to lower our rating on the certificates, such as increasing foreclosure rates in the underlying pool, house price declines, and changes in the pool composition. We have analyzed the effect of increased delinquencies by testing the sensitivity of the rating to two different levels of movements.

Increasing levels of delinquencies will likely cause more stress to a transaction, and would likely contribute to a downgrade of the rated certificates.

In our analysis, our assumptions for increased delinquencies are specific to a transaction, although these levels may be similar (or the same) across different transactions. The levels do not reflect any views as to whether these deteriorations will materialize in the future. However, our analysis already incorporates additional adjustments to the pool's default probability by projecting buckets of expected arrears.

Even under these scenarios, structural features in securitizations may mitigate these deteriorations in performance.

Further delinquencies of 16%

In the first scenario, in addition to the rating-dependent stress assumptions, we apply a further 16% increase in nonperforming HPPs. These are split equally between the one-month and three-month buckets. In the second scenario, we apply an increase of 16%, but all the HPPs are deemed to have missed three monthly payments. The default probability we assign to an HPP increases in tandem with the monthly payments missed. As a consequence, assuming that all HPPs have missed three monthly payments, the increase in the WAFF would be greater in the second scenario.

Tables 6 and 7 summarize the results of assuming increasing levels of delinquencies.

Table 6 - Scenario Analysis

Scenario Analysis			
Assuming An Additional 8% Of Arrears, Split Equally Between One Monthly Payment And Three Monthly Payments Missed			
Ratings	**WAFF (%)**	**WALS (%)**	**CC (%)**
AAA (sf)	31.40	49.73	15.61
AA (sf)	22.52	40.80	9.19
A (sf)	17.12	26.07	4.46
BBB (sf)	12.80	17.64	2.26
BB (sf)	8.44	12.24	1.03

WAFF--Weighted-average foreclosure frequency.
WALS--Weighted-average loss severity.
CC--Credit coverage

Table 7 - Scenario Analysis

Scenario Analysis			
Assuming An Additional 8% Of Arrears, Split Equally Between One Monthly Payment And Three Monthly Payments Missed			
Ratings	**WAFF (%)**	**WALS (%)**	**CC (%)**
AAA (sf)	34.40	49.73	17.11
AA (sf)	24.52	40.80	10.00
A (sf)	18.32	26.07	4.78
BBB (sf)	14.20	17.64	2.50
BB (sf)	9.44	12.24	1.15

WAFF--Weighted-average foreclosure frequency.
WALS--Weighted-average loss severity.

Under our scenario analysis, the rating on the certificates in the transaction is in line with our expectations in terms of the maximum potential deterioration for a 'AAA' rating level for one- and three-year horizons under moderate stress conditions, which are 'AA' and 'BBB', respectively (see "Methodology: Credit Stability Criteria," published on May 3, 2010).

We based our analysis above on a simplified assumption, i.e., that the increase in arrears materialized immediately on the day after closing. In reality, these are likely to occur over a period of time. Therefore, other factors, such as seasoning or repayments of some HPPs, could partially mitigate the effect of deteriorating performance of other HPPs.

Surveillance

We will maintain surveillance on the transaction until the certificates are fully repaid. To do this, we will analyze regular servicer reports detailing the performance of the underlying collateral, monitor supporting ratings, and make regular contact with the servicer to ensure that it maintains minimum servicing standards and that any material changes in the servicer's operations are communicated and assessed.

The key performance indicators in the surveillance of this transaction are:
- Increases in credit enhancement for the certificates;
- Total and 90-day delinquencies;
- Cumulative realized losses;
- FTV ratios;
- Constant prepayment rates; and
- Increases in the seasoning of the collateral pool.

Related Criteria

- Criteria - Structured Finance - General: Methodology And Assumptions: Assessing Pools Of European Residential Loans, Aug. 4, 2017.
- Legal Criteria: Structured Finance: Asset Isolation And Special-Purpose Entity Methodology, March 29, 2017.
- Criteria - Structured Finance - General: Ratings Above The Sovereign - Structured Finance: Methodology And Assumptions, Aug. 8, 2016.
- Criteria - Structured Finance - General: Methodology: Criteria For Global Structured Finance Transactions Subject To A Change In Payment Priorities Or Sale Of Collateral Upon A Nonmonetary EOD, March 2, 2015.
- Criteria - Structured Finance - General: Global Framework For Assessing Operational Risk In Structured Finance Transactions, Oct. 9, 2014.
- General Criteria: Methodology Applied To Bank Branch-Supported Transactions, Oct. 14, 2013.
- Criteria - Structured Finance - General: Counterparty Risk Framework Methodology And Assumptions, June 25, 2013.
- Criteria - Structured Finance - General: Criteria Methodology Applied To Fees, Expenses, And Indemnifications, July 12, 2012.
- General Criteria: Methodology: Credit Stability Criteria, May 3, 2010.
- Criteria - Structured Finance - General: Standard & Poor's Revises Criteria Methodology For Servicer Risk Assessment, May 28, 2009.

Related Research

- EMEA Sector Roundup: Trends And Emerging Risks December 2017, Dec. 5, 2017.
- Hope Overcomes Fears As The Fundamentals Propel Europe Forward, Dec. 5, 2017.
- U.K. RMBS Index Report Q3 2017, Nov. 22, 2017.
- European Economic Snapshots For 4Q17 Published, Nov. 15, 2017.
- Servicer Evaluation: Computershare Loan Services (HML), Oct. 5, 2017.
- 2017 EMEA RMBS Scenario And Sensitivity Analysis, July 6, 2017.
- Global Structured Finance Scenario And Sensitivity Analysis 2016: The Effects Of The Top Five Macroeconomic Factors, Dec. 16, 2016.
- European Structured Finance Scenario And Sensitivity Analysis 2016: The Effects Of The Top Five Macroeconomic Factors, Dec. 16, 2016.

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This presale report is based on information as of March 1, 2018. 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 Final ratings will depend upon receipt and satisfactory review of all final transaction documentation, including legal opinions. Accordingly, the preliminary ratings should not be construed as evidence of final ratings. If S&P Global Ratings does not receive final documentation within a reasonable time frame, or if final documentation departs from materials reviewed, S&P Global Ratings reserves the right to withdraw or revise its ratings.

Profile

Proposed U.S. dollar-denominated sukuk: assigned preliminary 'BB' issue rating.

Transaction Overview

This presale report is based on information dated March 1, 2018, and is posted in conjunction with the planned U.S. dollar-denominated $400 million-$500 million sukuk trust certificates by Alpha Star Holding V Ltd. (Alpha Star V), an exempted company incorporated with limited liability in the Cayman Islands. Under the sukuk documents, Alpha Star V will enter into, among other contracts, a sale and purchase undertaking agreement with project companies of Dubai-based residential property developer Damac Real Estate Development Ltd. (Damac; BB/Stable/--) and Majara Investments Ltd. (Murabaha counterparty). Alpha Star V will also enter into a guarantee agreement with Damac. We understand that the proceeds will be used for general corporate purposes.

Rationale

The preliminary 'BB' issue rating on the proposed sukuk reflects the guarantee by Damac and that the transaction fulfils the five conditions of our criteria for rating sukuk (see "Methodology For Rating Sukuk," published Jan. 19, 2015, on RatingsDirect):

- Damac has undertaken to make up any shortfall between the collections from the underlying assets and the periodic distributions and principal payable by Alpha Star V to investors through a corporate guarantee.
- Damac's obligations under the guarantee agreement are irrevocable.
- These obligations will rank pari passu with Damac's other senior unsecured financial obligations.
- Damac will undertake to cover all the costs related to the transaction through the servicing agency agreement and the guarantee undertaking for the benefit of Alpha Star V.
- Although the documentation mentions a risk of a total loss event (TLE), we view as remote the risk that a TLE would jeopardize the full and timely repayment of the sukuk. We base our rating on the guarantee that Damac will cover all accrued unpaid periodic distributions and principal in the event of a TLE (see section below "Total Loss Event").

The '3' recovery rating on the sukuk reflects our expectation of meaningful recovery of about 65%

for sukuk holders in the event of a default. Under our criteria, we therefore equalize the preliminary rating on the proposed sukuk with our long-term foreign currency issuer credit rating on Damac.

A sukuk structure that provides sufficient contractual obligations for full and timely repayment, backed by a corporate guarantee

We understand that the issuer, Alpha Star V, will use the proceeds of the sukuk as follows:

- No more than 67% of the sukuk proceeds to acquire a portfolio of commodities (Murabaha assets).
- Not less than 33% of the sukuk proceeds to be held in the Ijara portfolio (lease financing).

Under the Ijara agreements, Alpha Star V will lease the Ijara assets to Damac's project companies. The amount of rent will be calibrated to match the amount payable as a periodic distribution to sukuk holders, plus a supplemental rental element that will be set off against any service charge amount incurred by the Ijara servicing agent over the same period. In addition, the profit element of the deferred sale price under the Murabaha agreement will be paid by Majara Investments Ltd. at regular intervals coinciding with the periodic distribution dates. In case of a shortfall, Damac has undertaken to step in and pay the distribution shortfall restoration amount. This is the shortfall between the profit collections available for distribution and the periodic distribution amount due to and scheduled for distribution to certificate holders on that date.

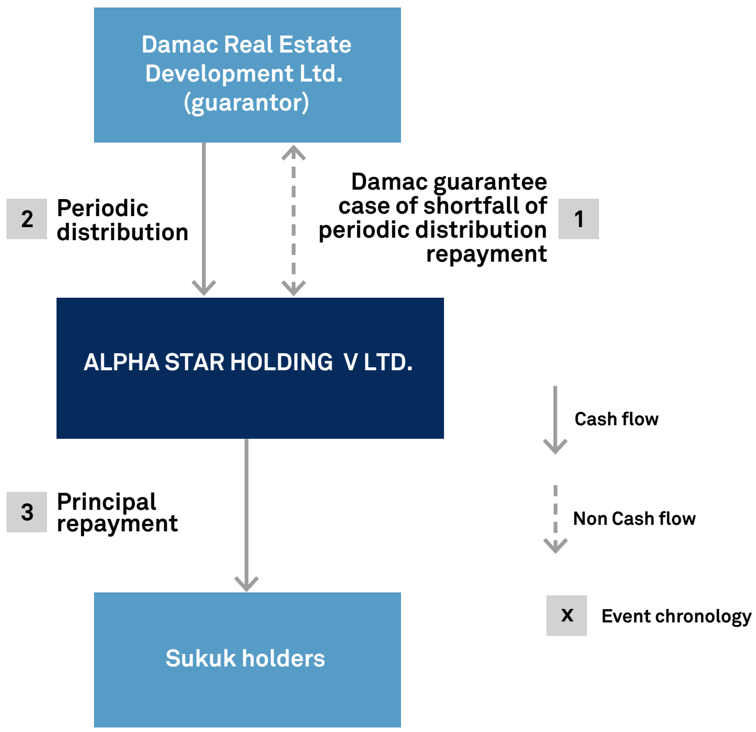
At the maturity date of the transaction or upon an early dissolution event, sukuk liquidation proceeds will be paid out including:

- The exercise price of purchase undertaking;
- The cost price from the Murabaha agreement;
- Relevant insurance or insurance shortfall indemnity proceeds (if any) generated from the Ijara agreements; and

Table 1 - Transaction Details

Transaction Details	
Issuer, Trustee	**Alpha Star Holding V Ltd.**
Sponsor	Damac Real Estate Development Ltd.
Arrangers	Barclays Bank PLC, HSBC Bank plc, Emirates NBD PJSC, Dubai Islamic Bank PJSC, KAMCO Investment Company K.S.C.P.
Principal paying agent	Citibank, N.A., London Branch
Delegate	Citibank, N.A., London Branch
Governing law	English Law

Chart 1 - Principal Repayment



- Any accrued but unpaid rental amounts in respect of the Ijara agreements and accrued but unpaid profit in respect of the Murabaha agreement.

Any shortfall compared with the amount payable toward the certificate holders will be covered by Damac under the guarantee agreement.

Total Loss Event

While the documentation mentions a risk of a TLE, we view as remote the risk that a TLE would jeopardize the full and timely repayment of the sukuk. If a TLE occurred, it would typically be mitigated by Damac's guarantee to provide full payment of principal and accrued unpaid profit. The Ijara servicing agent has the obligation to ensure that the assets are covered by insurance and also to make up any shortfall between insurance proceeds and the principal amount, unless it proves beyond any doubt that it has complied with its insurance obligations. Although this exclusion might result in a residual exposure of investors to the underlying Ijara assets' risks, we base our rating on the guarantee that Damac will cover all accrued unpaid periodic distributions and principal in the event of a TLE.

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

Related Criteria

- Criteria - Corporates - General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016.
- General Criteria: Guarantee Criteria, Oct. 21, 2016.
- General Criteria: Methodology For Rating Sukuk, Jan. 19, 2015.
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014.
- General Criteria: Group Rating Methodology, Nov. 19, 2013.
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013.
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013.
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013.
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012.

Related Research

- Dubai-Based Real Estate Developer Damac's New Sukuk Assigned Preliminary 'BB' Ratings, April 3, 2018.

Recovery And Resolution Regimes In The Gulf Cooperation Council:
More Questions Than Answers

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Banks in the Gulf routinely adopt many of the best practices and international regulations when they come into force, but governments in the region are taking their time to implement resolution regimes. Faced with a global financial crisis demanded urgent and exceptional actions, the G7 finance ministers agreed to take decisive action, using all available tools to support some systemically important financial institutions and prevent their failures. As part of their post-crisis reform, and in order to minimize the need for government intervention and related costs for tax payers, regulators have enhanced their monitoring and supervision methodologies, revamped on-site examination processes, and, in many countries, expanded their toolkit to process orderly resolutions of systemically important banks.

Although GCC countries have taken many of these steps, they are still far from the implementation of resolution regimes for both conventional and Islamic banks. (The GCC comprises Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates [UAE]). Such implementation would require a significant change in mentality and the governments' approach toward their banking systems. S&P Global Ratings currently considers the governments in most GCC countries as highly supportive toward their banking systems. For instance, Qatar recently provided substantial support to its banking system following significant outflows of external funding in the wake of sanctions from a few Arab countries. For Islamic banks, however, the Sharia implications compound the challenge of the implementation of resolution regimes and the bail-in of liabilities.

Overview

- GCC countries have yet to adopt recovery and resolution regimes.
- We classify the governments of the GCC countries as highly supportive toward their banking systems, except in Oman where we view the authorities as supportive, and Bahrain where we assess support as uncertain, primarily due to the more limited capacity of these governments to extend such support.
- Sharia interference compounds the challenges of implementing resolution regimes and bail-in of liabilities, creating a situation that reinforces the need for standardization of Sharia interpretation.
- If a GCC country implements an effective recovery and resolution regime, we would review our assessment of its propensity to support its banking system and reassess the impact on our ratings on the affected banks.

It's Just A Matter Of Time

To our knowledge, none of the six GCC countries has made marked progress in the implementation of recovery and resolution regimes. According to the Financial Stability Board (FSB), Saudi Arabia, which is part of the G20, is still to present its resolution bill for public consultation.

In our opinion, rolling out recovery and resolution regimes would require a profound change in mentality and in governments' approach to support their banking system. Governments in the GCC, not only as shareholders, but also to safeguard the financial stability of their banking systems, have not hesitated to intervene strongly to rescue banks. The most recent intervention took the form of a $43 billion liquidity injection, as of Dec. 31, 2017, in the Qatari banking system to help curb the repercussions of the foreign funding outflows in the aftermath of Qatar's boycott by a group of Arab states. Qatari authorities also intervened in 2009 through capital injections to help banks coping with the drop in stock market and real estate prices. Other examples include the placement of $19 billion by the Ministry of Finance in UAE banks in 2008, which it converted subsequently into additional capital instruments. Similarly, the Government of Abu Dhabi injected $4.3 billion of new capital into its banks in 2009.

Recovery, Resolution, And Bail-In: What Is It?

Recovery planning's main goal is to enable banks to restore their creditworthiness through specific actions prior to the need of a bailout from the authorities. Recovery would typically take the form of recapitalization or other restructuring, such as assets sales. Resolution planning considers what happens if the bank fails to recover--that is, if a bank becomes nonviable. At this stage, it consists of the regulators identifying the best approach to stabilize the institution and how to avoid contagion to other parts of the financial system, while winding down the unviable segments of the business. The regulators use their authority to force banks to remedy any barriers to an effective resolution, such as obliging banks to enhance their bail-in buffers to facilitate recapitalization and organizational changes.

The key attributes of effective resolution regimes for financial institutions include, among others:

- Resolution authority and powers. An administrative authority or authorities would supervise the process. This supervising body would have the capacity to remove the senior management from the failing institution, appoint an administrator, manage operations, and carry out resolution, while transferring assets and liabilities to a solvent party. The acting supervisors would take into account the resolution plan without being bound by it.
- Recovery and resolution planning. A strategy that provides firms in danger of failure with multiple options for restoring their creditworthiness in scenarios of capital shortfall and liquidity stress. Also, regulators would determine banks' specific minimum total loss-absorbing capacity (TLAC) requirement that, based on prudent assumptions of losses prior to resolution and following the revaluation of assets, should be sufficient to recapitalize the failed entity and ensure continuity of critical operations. More importantly, the bail-in of these instruments should not trigger cross defaults on other more senior instruments. Measures to ensure the effective provision of liquidity support, if necessary, are also a critical element.

For a long time, investors perceived government support as a stabilizing factor for banks' creditworthiness, given the strong balance sheets of some of the GCC governments. Nevertheless, GCC countries are typically among the first to implement new international standards, and therefore we think their implementation of recovery and resolution regimes is just a matter of time. How much longer before this happens, however, is still a question.

For conventional banks, bail-in-able liabilities are likely easy to identify and might consist primarily of instruments that are contractually bound to absorb losses at a certain stage (whether at the point of non-viability or earlier). Most of the recent capital increase in the GCC took the form of loss-absorbing hybrid instruments instead of core equity injections. For Islamic banks, Sharia interference may complicate the implementation of recovery and resolution regimes.

The Complexities For Islamic Banks

There is a common perception that recovery and resolution regimes should be easy to implement in Islamic finance, as one of the principles of Islamic finance requires fair profit and loss-sharing between participants of a transaction, meaning natural and automatic bail-in. We recognize that it is more complex for the following reasons:

- Banks conduct some of their operations in a debt-like format;

- Covering losses other than those incurred on the specific underlying assets is not possible according to Sharia principles;

- A lack of clarity on the type of instruments that can be bailed-in; and

- Asset transfer could be problematic.

Because aspects of Islamic finance emulate debt contracts, these instruments will likely rank at the bottom end of the loss-absorbing instruments (i.e. will probably have very limited loss absorbency) or be completely excluded, as they do not meet the FSB's recommended TLAC characteristics. Murabaha-based profit sharing investment accounts (PSIAs) expose account holders to the bank's inability to fulfill its promise to pay the principal or the remuneration. Similarly, in a current account operation, the client takes the risk that the bank cannot repay the principal. Finally, a sukuk with contractual obligations of its sponsor, which cover periodic distributions, principal, and ranks as senior unsecured, would be subject to the same type of risks.

An Islamic bank cannot use the capital of Mudaraba-based PSIAs to support the losses on activities financed by other sources. In Islamic finance, the capital of a Mudaraba PSIA should cover, in theory, the losses incurred on the specific underlying assets of that Mudaraba PSIA. In reality, banks have developed specific techniques to minimize the risk of sharing losses with their customers in order to prevent liquidity risks (such as the risk of bank run) or franchise erosion. These include setting aside profit equalization reserves or investment risk reserves. That means that if a bank were to come to the point of resolution, the activity that was financed using Mudaraba PSIAs should be excluded from the bail-in exercise, assuming that the losses that would have led to the bank's failure do not stem from this activity. Under the latter scenario, the strict application of Sharia would mean that PSIAs depositors bear the losses. Factoring in the potential impact of IFRS 9--FAS 30 for Islamic banks --we anticipate:

- A real segregation between the management of Mudaraba PSIAs and other types of funding (such as separating the activity financed by PSIAs from the activity financed by other sources and requiring PSIAs to effectively share the losses if needed); or

- A decline in Mudaraba PSIAs's attractiveness in the medium term for both the customers and the banks themselves.

In addition, distinguishing the bail-in-able instruments from those that are not isn't a clear task. The logic used for PSIAs could also apply to Mudaraba sukuk used for the acquisition of specific assets, unless the Mudaraba agreement states that it is a participation in the general pool of assets of the bank. While Musharaka sukuk, in our view, is an easy call because it is similar to pure equity.

Furthermore, according to Sharia principles, transferring assets with debt-like characteristics from one entity to another is possible only at par (or, with no haircut). This complicates an effective management-led recovery plan, or resolution, under which selected assets and liabilities should be moved from the failed bank to a viable entity.

What Will It Take To Make It Work?

We think that the introduction of recovery and resolution regimes in jurisdictions where Islamic finance is significant could provide regulators with an additional tool to help the industry's financial stability. As we have seen in Europe and the U.S., once fully implemented, recovery and resolution regimes become credible alternative to bailouts and, in turn, help preserve financial stability. Similarly, we see an emerging model in other jurisdictions, such as Hong Kong, where regulators introduced resolution as a new additional tool, even if government support for senior creditors seems likely to remain. This approach could also support financial stability. At this stage, we are uncertain which path the GCC governments will take.

For Islamic banks specifically, in our view, the effective introduction of recovery and resolution regimes would hinge on clarifying which instruments will absorb losses other than in the event of default. We think that loss-absorbing instruments could include the Musharaka/ Mudaraba-based products, where there is limited liquidity or reputation risks for the bank. These instruments include restricted PSIAs (no commingling between the bank's activity and that financed by these instruments), and on balance-sheet PSIAs, provided that clients understand that they take the risk of losing their capital; receive proper remuneration for that risk; and contribute to the general pool of the bank's assets. The instruments that GCC banks used to bolster their capital over the last three years (i.e. Mudaraba sukuk) are also potentially loss-absorbing. However, the market's appetite for these instruments once their loss-absorbing features are made clearer is untested.

Another key to the success of a recovery and resolution framework in the GCC, in our opinion, is better protection of the senior creditors in case of resolution. Customers bear the institution's credit risk in Murabaha, Ijara, or any other Islamic finance transaction that creates a direct and senior link between the risks taken by the clients and the creditworthiness of the bank. For these activities, the bank could be subject to higher capital requirements or holding TLAC instruments (similar to the aforementioned instruments) that will be bailed in and safeguard the senior creditors.

Two Possible Rating Scenarios

S&P Global Ratings introduced its "Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity" on April 28, 2015, to factor in the changes in the global regulation and the possible extraordinary support under effective resolution regimes that could benefit senior creditors if a bank fails. Under our additional loss-absorbing capacity (ALAC) methodology, we assess:

- Based on legislative and regulatory features, if ALAC will reduce default risk on a bank's senior unsecured obligations, supporting the issuer credit rating;

- The features of instruments that are eligible for inclusion in ALAC;

- The quality and quantity of ALAC liabilities as a proportion of risk-weighted assets that will uplift an ICR on a bank above its stand-alone credit profile (SACP); and

- The interaction between support based on ALAC and other forms of positive and negative external intervention, including government support, group support, guarantees, and additional short-term support, among other forms of external support.

Generally, when a country moves to implement an effective recovery and resolution regime, we would review our assessment of its propensity to support its banking system and reassess the ensuing impact on the banks' credit quality. At this stage, we have seen two possible scenarios:

- ALAC uplift replaces fully or partially government support to reflect the additional protection offered by these instruments to senior creditors.

- Both government and ALAC uplift become available, leading us to likely incorporate into an ICR the higher of the two.

Related Research

- GCC Banks Should See A More Stable Financial Footing In 2018, Jan. 9, 2018.
- Hong Kong Moves Toward Effective Resolution Regime With Loss-Absorbing Capacity Requirements; No Immediate Rating Impact, Jan. 23, 2018.
- Capitalization At Gulf Banks Is One Of The Main Strengths Supporting Their Ratings, Oct. 25, 2017.
- An Illustrative Rating Path For A Systemic Bank In A Bail-In Resolution, Oct. 4, 2017.
- Proposed Accounting Standard FAS 30 Aligns Islamic Banks With IFRS 9, But May Have Unintended Consequences, Sept. 27, 2017.
- Islamic Finance In 2018: Slow Growth Is The New Normal, June 20, 2017.
- The Overall Effect Of IFRS 9 On Rated Gulf Cooperation Council Banks' Financial Profiles Will Be Manageable, May 29, 2017.
- GCC Islamic Banks Stay On Course Through Glum Operating Conditions, April 18, 2017.
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GCC Islamic Banks' Financial Profiles To Stabilize In 2018

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S&P Global Ratings believes that, absent any materialization of geopolitical risks, the financial profiles of Islamic banks in the six Gulf Cooperation Council (GCC) countries will stabilize through 2018. Asset growth should remain in the low single digits due to slow economic growth, unless oil prices rebound significantly.

We also anticipate that Islamic banks' asset quality will stabilize by midyear 2018 --except for Qatari banks where we still see some increasing risks, particularly in the hospitality and real estate sectors. However, Islamic banks' cost of risk will increase due to the adoption of International Financial Reporting Standards (IFRS) 9, or Financial Accounting Standards (FAS) 30 for banks reporting under Accounting and Auditing Organization for Islamic Financial Institutions' standards. We expect that this increase, combined with the impact of the introduction of value-added tax (VAT) in 2018, will result in a slight decline in GCC Islamic banks' profitability. At the same time, however, these banks continue to display strong capitalization by global standards, albeit with signs of quantitative and qualitative deterioration.

Key Takeaways

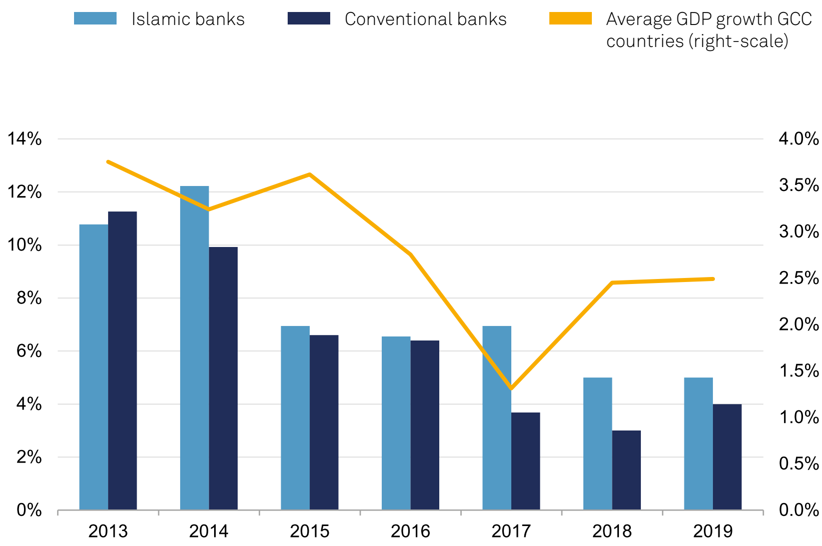
- We expect GCC Islamic banks' total asset growth will remain in the low single digits over the next12-24 months, after stabilizing at about 4% for the GCC system and about 7% across our sample in 2017.
- We believe that GCC Islamic banks' financial profiles will start to stabilize from the second half of 2018,absent any materialization of geopolitical risks.
- The three key risks that we foresee for GCC Islamic banks are regional geopolitical tensions, higher cost of risk,and lower profitability.

To assess the financial performance of Islamic and conventional banks in the GCC, we used a sample of 17 Islamic banks and 27 conventional banks with total assets in excess of $1.9 trillion and sufficient financial disclosures. In 2017, Islamic banks in our sample (see the Appendix for additional details) displayed strong asset-quality indicators, profitability, and capitalization by global and regional standards.

Islamic Banks' Growth Has Moderated

The end of the triple-digit-oil-price era has significantly slowed GCC economies and reduced growth opportunities for their banking systems (see chart 1). We forecast that oil prices will stabilize at $60 per barrel in 2018 and $55 in 2019. For the six GCC countries, we anticipate an unweighted average economic growth of 2.5% in 2018-2019, or less than half of the growth they delivered in 2012.

Chart 1 - Asset Growth Of Islamic Versus Conventional Banks



Source: S&P Global Ratings, banks' financial statements. GCC--Gulf Cooperation Council. See Table 5 and Table 6 for thecomposition of our sample for Islamic and conventional banks.

Table 1 - Balance Sheet Growth In Selected GCC Islamic Bank Markets

(Mil. $)	2013	2014	2015	2016	2017
Qatar					
Balance sheet growth	58,098	69,419	81,381	87,866	95,756
Annual growth rate (%)	12.1	19.5	17.2	8.0	9.0
Relative weight is sample (%)	16.5	17.6	19.3	19.6	19.9
Kuwait					
Balance sheet growth	78,457	85,688	83,461	83,560	89,138
Annual growth rate (%)	7.9	9.2	(2.6)	0.1	6.7
Relative weight is sample (%)	22.3	21.7	19.8	18.6	18.6
Saudi Arabia					
Balance sheet growth	107,412	121,264	124,563	136,138	140,366
Annual growth rate (%)	8.2	12.9	2.7	9.3	3.1
Relative weight is sample (%)	30.6	30.8	29.6	30.3	29.2
United Arab Emirates					
Balance sheet growth	86,212	94,203	107,392	118,014	129,471
Annual growth rate (%)	16.2	9.3	14.0	9.9	9.7
Relative weight is sample (%)	24.6	23.9	25.5	26.3	27.0
Total	351,116	394,026	421,401	448,993	480,176

Source: S&P Global Ratings, banks' financial statements.

While overall lending growth slowed down in 2013-2017, Islamic banks in our sample saw more rapid growth of 6.9% than the 3.7% we saw for conventional banks (see table 1). The strong performance of a few Islamic banks in our sample (particularly Kuwaiti, Qatari, and United Arab Emirate [UAE]-based Islamic banks) explain this strong overall performance. In 2018-2019, we expect growth will converge with that of conventional banks, but that Islamic banks will continue to expand at a marginally faster rate. We expect the Islamic banks' financing growth will reach 4%-5%, supported by strategic initiatives such as the Dubai Expo 2020, Saudi Vision 2030, the World Cup 2020 in Qatar, and higher government spending in Kuwait led by Kuwait 2035 Vision, the country's national development plan. A surge in geopolitical risk and ensuing delays of some of these initiatives could negatively affect our base-case scenario.

Asset Quality Is Likely To Stabilize

Asset quality of GCC Islamic banks remains slightly weaker than their conventional counterparts. Due to the asset-backing principle of Islamic finance, Islamic banks tend to have higher exposure to the real estate sector. Furthermore, because Sharia law forbids charging repayment delay penalties, some clients tend to prioritize their repayments to conventional banks. As we do not foresee any significant changes in these two structural factors, we believe that the asset-quality indicators of Islamic banks will remain slightly weaker than their conventional peers'.

Over the past 12 months, the asset-quality indicators of Islamic banks in our sample deteriorated slightly (see table 2), similar to those of their conventional peers. However, the deterioration was not commensurate with the economic slowdown experienced in their various home countries.

In a normal cycle, banks restructure their exposures to adopt the financing payables to the new cash-flow realities of their clients. At some point during the cycle, some of these financings generate new non-performing loans (NPLs), which we believe we are currently beginning to see. With the recent adoption of IFRS9 and FAS30, the impact of these loans on Islamic and conventional banks' cost of risk will become more visible. Loans that are restructured, or past due but not impaired, will generally necessitate lifetime expected loss provisioning instead of 12-months expected loss provisioning. Therefore, when the economic cycle turns, we would expect to see a spike in provisions, rather than a slight decline as we have seen across our sample of Islamic banks over the past 12 months. That said, we think that banks will try to frontload some of the impact, in 2018, to avoid future result volatility (as they charge the initial impact to equity). We think that the success of IFRS9 or FAS30 adoption will depend largely on how aggressive management teams are in recognizing asset-quality issues. We expect cost of risk to increase in the next 24 months to reflect the transition to the new regulations. Some market observers argue that Islamic banks will fare better with the transition compared with their conventional peers due to the asset backing principle of Islamic finance. However, we are of the view that collateral realization is still difficult in the GCC, although some authorities have implemented more creditor-friendly regulations over the past two years. Under our base-case scenario, we think NPLs could increase to 4%-5% over the next two years, with credit losses increasing by more than 50% over the same period (see table 2).

Table 2 - Asset-Quality Of Islamic Versus Conventional Banks

(%)	2013	2014	2015	2016	2017
Islamic banks					
Non performing advances ratio	4.2	3.3	3.0	3.1	3.2
Non performing advances coverage	106.5	114.2	128.4	135.3	131.6
New loan loss provisions (LLP) /average customer loans	1.0	0.9	0.9	0.8	0.7
New loan loss provisions / net operating revenues before LLP	30.3	29.2	27.5	28.4	25.2
Conventional banks					
Non performing advances ratio	3.5	2.9	2.5	2.7	2.7
Non performing advances coverage	133.0	165.2	167.0	156.9	152.9
New loan loss provisions / average customer loans	1.0	0.9	0.9	1.2	1.1
New loan loss provisions / operating revenues	26.6	22.3	24.3	32.0	27.6

Source: S&P Global Ratings, banks' financial statements. See Table 5 and Table 6 for the composition of our sample for Islamic and conventional banks.

Table 3 - GCC Islamic Banks' Key Funding and Liquidity Metrics

(%)	2013	2014	2015	2016	2017
Growth in customer deposits	N.A.	14.0	6.0	5.4	6.4
Liquid assets / total assets	24.7	23.4	22.1	21.3	21.0
Customer loans (net) / customer deposits	87.1	88.8	92.3	93.2	93.3

N.A.--Not available.

Source: S&P Global Ratings, banks' financial statements. See Table 5 for the composition of our sample for Islamic banks.

Funding And Liquidity Profiles Are Strengthening

Growth in customer deposits recovered slightly in 2017, a trend that we expect will continue. This was the result of stabilized oil prices and the channeling of higher public-sector deposits to the banking systems. In some markets, deploying the new inflow of Islamic liquidity is a challenge for banks, especially in the absence of significant local sukuk issuance. While the volume of sukuk issuance increased in 2017 thanks to jumbo issuances by some GCC countries, issuance volume is currently uncertain for 2018. Therefore, we expect liquidity will continue to build in Islamic banks' balance sheets. We think banks will use this liquidity and corporates whenever they are available.

In the GCC, both Islamic and conventional banks enjoy strong funding profiles, thanks to the predominance of core customer deposits and their relatively low financing-to-deposit ratios. We reflect this in our Banking Industry Country Risk Assessments through our assessment of systemwide funding, which positively influences our assessment of the starting point of bank ratings. At year-end 2017, the average financing-to-deposit ratio of GCC Islamic banks in our sample reached 93.3%, and the liquid assets to total assets ratio was about 21%. Islamic banks tend to attract retail depositors due to their Sharia-compliant nature. The use of wholesale funding sources remains relatively limited, and we expect this will continue.

Profitability To Deteriorate Slightly Over The Next Two Years

We anticipate that GCC Islamic banks' profitability will deteriorate slightly in 2018 and 2019. In the past 12 months, the return on assets of Islamic banks in our sample was almost stable, as the stronger performance of some banks compensated for the drop experienced by about half of the banks. Several factors explain our expectations for 2018-2019, including:

- Financing growth will remain limited. Banks will continue to prioritize quality over quantity and avoid lucrative but higher risk exposures; especially since IFRS9/FAS30 require lifetime provisioning for exposures that experience deterioration of credit quality or repayment issues.
- Cost of risk will increase and stabilize at a higher level. Restructured loans and past due but not impaired loans that will slip to nonperforming categories, and new IFRS9/FAS30 provisions are likely to push cost of risk higher for over a longer period.
- Operating costs are likely to increase because of VAT introduction, although we believe that banks will pass most of the impact to end users.
- While banks continue to benefit from large amounts of free deposits, we anticipate that some corporate depositors will seek to improve their profitability and become more demanding as interest rates continue to rise.

Table 4 - GCC Islamic Banks' Return On Assets

(%)	2013	2014	2015	2016	2017
Net Islamic margin to average earning assets	2.8	2.8	2.7	2.5	2.6
New loan loss provisions / average customer loans	1.0	0.9	0.9	0.8	0.7
Return on assets	1.5	1.5	1.6	1.4	1.5
Noninterest expenses/operating revenues	41.5	40.7	39.1	40.7	40.6

Source: Source: S&P Global Ratings, banks' financial statements. See Table 5 for the composition of our sample for Islamic banks.

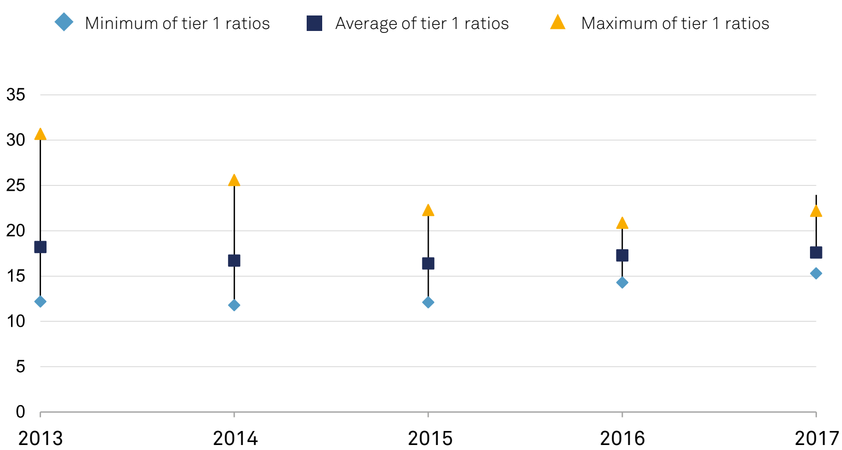
We therefore expect revenue growth will decelerate and banks will focus on their cost base to mitigate the impact. Financial technology collaboration and the use of technology for low added-value transactions, such as money transfer and payments, could offer some opportunities in this area. As for their conventional counterparts, we expect the low cost base of GCC Islamic banks to protect their profitability (see table 4). It is important to mention that our base-case scenario excludes any escalation of geopolitical risk in the region. If that were to be the case, the impact on both Islamic banks and conventional banks could be significant.

Strong Capital Buffers Shelter Against Shocks

The GCC Islamic banks included in our sample continue to display strong capitalization by international standards, with an unweighted average tier 1 ratio of 17.6% at year-end 2017. A mix of still good profitability, somewhat conservative dividend payout, and low growth explain the slight increase in this ratio compared with the previous year. We note, however, that for most banks, capitalization remains below the highs that we observed in the past because previous rapid growth of financing has not been matched with additional capital-raising exercises (see chart 2).

A few Islamic banks have issued capital-boosting sukuk, primarily in the UAE, Qatar, and Saudi Arabia. The common characteristic of these sukuk is that they allow for loss absorption at some point (in case of a nonviability event for tier 2 sukuk and generally at issuer discretion for tier 1). In our view, these sukuk help the industry to inch closer to the application of one of its cardinal principles, which is profit and loss sharing.

Chart 2 - GCC Islamic Banks' Reported Tier 1 Ratios



Source: Source: S&P Global Ratings, banks' financial statements. See Table 5 for the composition of our sample for Islamic banks.

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

To our knowledge, none of the six GCC countries has made marked progress in the implementation of recovery and resolution regimes. In our opinion, rolling out recovery and resolution regimes would require a profound change in mentality and in governments' approach to support their banking systems. As shareholders, and to safeguard the financial stability of their banking systems, governments in the GCC have not hesitated to intervene to rescue banks. There is a common perception that recovery and resolution regimes should be easy to implement in Islamic finance, due to the principle of profit and loss sharing that means, in theory, natural and automatic bail-in. We recognize that it is more complex for the following reasons:

- Banks conduct some of their operations in a debt-like format;
- Covering losses other than those incurred on the specific underlying assets is not possible according to Sharia principles;
- A lack of clarity on the type of instruments that can be bailed-in; and
- Potentially problematic asset transfer.

Appendix: Composition Of Our Sample

In order to assess the financial performance of Islamic and conventional banks in the GCC, S&P Global Ratings has used a sample of 17 Islamic banks and 27 conventional banks with total assets in excess of $1.9 trillion and sufficient financial disclosures. We have not included the Islamic windows/activities of conventional banks, owing to a lack of disclosure and the risk of distortion of data (as these windows/activities benefit from the overall support of their respective groups in the form of funding or cost sharing, for example).

Study sample details

Table 5 - S&P Global Ratings' Sample Of GCC Islamic Banks

	Country	Islamic Bank Ranking	Overall Ranking	Assets (bil.$)
Al Rajhi Bank	Saudi Arabia	1	5	91.5
Kuwait Finance House	Kuwait	2	10	57.5
Dubai Islamic Bank	United Arab Emirates	3	11	56.4
Qatar Islamic Bank Q.P.S.C.	Qatar	4	15	41.3
Abu Dhab iIslamic Bank PJSC	United Arab Emirates	5	18	33.6
Bank Al-inma	Saudi Arabia	6	20	30.7
Masraf Al Rayan	Qatar	7	24	28.3
Al Baraka Banking Group B.S.C.	Bahrain	8	28	25.4
Bank Aljazira	Saudi Arabia	9	31	18.2
Emirates Islamic Bank PJSC	United Arab Emirates	10	32	16.8
Barwa Bank Q.S.C.	Qatar	11	35	13.4
Boubyan Bank K.S.C.P.	Kuwait	12	37	13.2
Qatar International Islamic Bank	Qatar	13	38	12.8
AlHilal Bank PJSC	United Arab Emirates	14	39	12.2
Ahli United Bank K.S.C.P	Kuwait	15	40	12.1
Sharjah Islamic Bank	United Arab Emirates	16	42	10.4
Kuwait International Bank K.S.C.P	Kuwait	17	44	6.3

*Ranking by total assets. GCC--Gulf Cooperation Council.

Source: S&P Global Ratings. Data as of Dec. 31, 2017.

Table 6 - S&P Global Ratings' Sample Of GCC Conventional Banks

	Country	Conventional Bank Ranking	Overall Ranking	Assets (bil.$)
Qatar National Bank	Qatar	1	1	222.8
First Gulf Bank PJSC	United Arab Emirates	2	2	182.1
Emirates NBD PJSC	United Arab Emirates	3	3	128.1
The National Commercial Bank	Saudi Arabia	4	4	118.4
National Bank of Kuwait S.A.K.	Kuwait	5	6	86.2
Abu Dhabi Commercial Bank PJSC	United Arab Emirates	6	7	72.1
Samba Financial Group	Saudi Arabia	7	8	60.7
Riyad Bank	Saudi Arabia	8	9	57.7
Banque Saudi Fransi	Saudi Arabia	9	12	51.4
The Saudi British Bank	Saudi Arabia	10	13	50.0
Arab National Bank	Saudi Arabia	11	14	45.8
The Commercial Bank of Qatar	Qatar	12	16	38.0
Mashreq bank	United Arab Emirates	13	17	34.1
Ahli United Bank B.S.C.	Bahrain	14	19	33.2
Arab Banking Corp. B.S.C.	Bahrain	15	21	29.5
Union National Bank PJSC	United Arab Emirates	16	22	29.3
Bank Muscat S.A.O.G.	Oman	17	23	29.0
Al Awwal Bank	Saudi Arabia	18	25	26.6
Doha Bank Q.S.C.	Qatar	19	26	25.7
Gulf International Bank B.S.C.	Bahrain	20	27	25.5
Burgan Bank	Kuwait	21	29	24.6
Gulf Bank	Kuwait	22	30	18.8
Commercial Bank of Kuwait	Kuwait	23	33	14.6
Al Ahli Bank of Kuwait	Kuwait	24	34	14.4
The National Bank of Ras Al-Khaimah	United Arab Emirates	25	36	13.2
Ahli Bank Q.S.C.	Qatar	26	41	11.0
National Bank of Fujairah PSC	United Arab Emirates	27	43	10.0

*Ranking by total assets. GCC--Gulf Cooperation Council.

Source: S&P Global Ratings. Data as of Dec. 31, 2017.

Related Research

- The Future Of Banking: Islamic Finance Needs Standardization And FinTech To Boost Growth, April 16, 2018.
- Recovery and Resolution Regimes In The Gulf Cooperation Council: More Questions Than Answers, Feb. 11, 2018.
- GCC Banks Should See A More Stable Financial Footing In 2018, Jan. 9, 2018.
- Global Sukuk Market Outlook: Another Strong Performance In 2018?, Jan. 8, 2018.
- Islamic Finance In 2018: Slow Growth Is The New Normal, June 20, 2017.

Only a rating committee may determine a rating action and this report does not constitute a rating action.

Islamic Finance In Africa Needs Conducive Economic And Regulatory Environments

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Conducive economic and regulatory environments are the first step for the development of Islamic finance in any jurisdiction. S&P Global Ratings believes that African countries need stronger reforms to help the development of a local Islamic finance industry. The latter could contribute, at least modestly, in helping the continent achieve many challenges from making banking services more accessible to the financing of infrastructure needs. Islamic finance also has to show African countries a benefit beyond compliance with Sharia. Investor base diversification or offering banking services at a competitive cost could attract the attention of African regulators and policymakers. Freeing up financing capacity on the balance sheets of multilaterals active in the continent could also be an alternative route especially at a time when some of them face significant capital constraints.

Key Takeaways

- We believe that the economic and regulatory environments in most African countries are still not yet conducive to Islamic finance.
- As a result, we believe its contribution to the development of the continent will remain limited in the next few years.
- Islamic finance needs to show an economic benefit beyond compliance with Sharia to attract policymakers' and customers' attention.
- Multilaterals could help by designing strategies and reforms to that end, and at the same time exploit the opportunity of sukuk to free up their lending capacity.

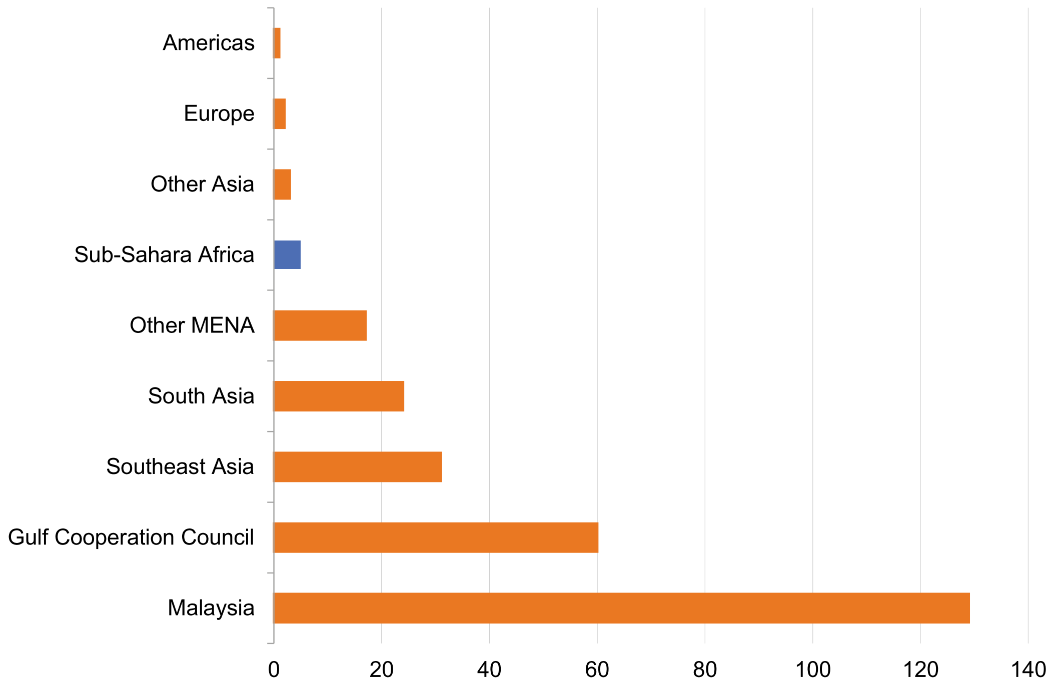
We estimate the assets of the global Islamic finance industry at about $2.1 trillion at year-end 2017, of which $1.7 trillion is banking assets. Africa's contribution remains meager with less than 2% of global consolidated assets and 1% of the sukuk issuance. Only a handful of Islamic banks have licenses to operate in the continent and very few countries have issued sukuk over the last decade.

We expect Islamic banks to continue playing a modest role in the continent in the next few years. While some African customers might naturally lean toward Islamic financial solutions if they were available, we are of the view that most clients will be more sensitive to the economic benefits. Multilaterals could help pave the way to that end by helping Sub-Saharan countries design the appropriate strategies and reforms.

Islamic Finance Is Still Negligible In Africa, And We Do Not Foresee Significant Change In The Next Two Years

There are few Islamic financial institutions active in Africa, and the industry 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 - Islamic Finance Development Indicator For Sub-Sahara Africa Versus Other Regions And Countries

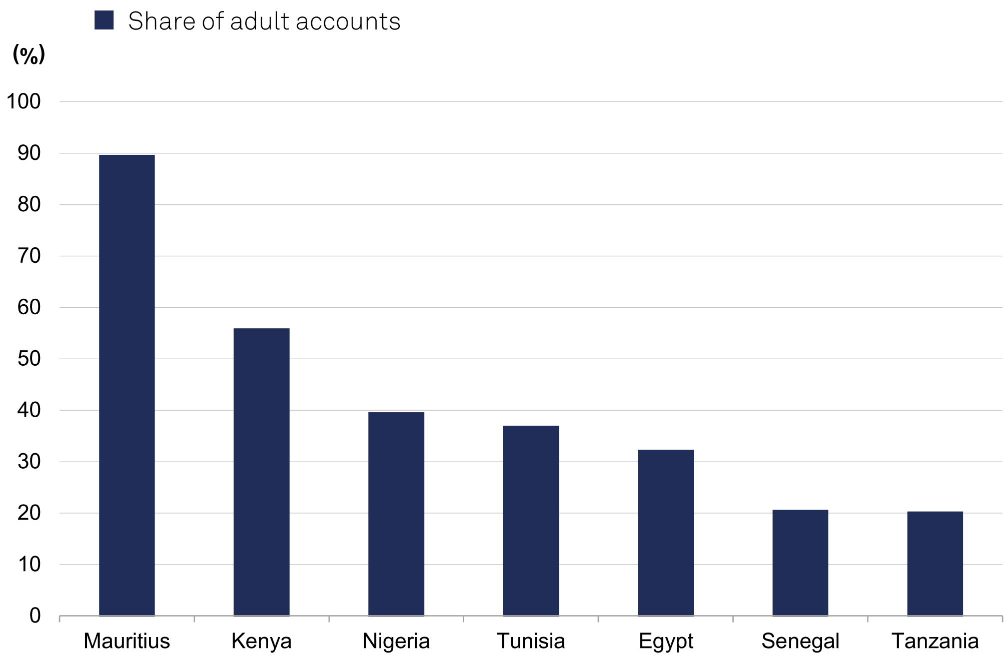


Source: ICD-Thomson Reuters, Islamic Finance Development report, 2017.

What Would It Take For Islamic Finance To Prosper In Africa?

Numerous African countries rank at the bottom of the Ease of Doing Business Index and have very low banking penetration rates (see chart 3). In addition, Africa reportedly needs more than $100 billion every year to close its infrastructure deficit, which requires recourse to all available financing solutions. While multilaterals already make significant contribution, they have their own limitations. Islamic finance could contribute to the development of the continent, though modestly in our view. Such a contribution requires, however, the implementation of significant reforms to make the economic and financial environments more conducive. Access to electricity and communication, industrialization, and regional integration could unlock growth opportunities in the continent. Islamic finance could help finance some of these opportunities, assuming the implementation of a specific regulatory framework to organize the activities of Islamic banks. The continent could benefit from the experience of Islamic finance advanced countries (such as Malaysia or some countries of the Gulf Cooperation Council). Malaysia implemented a specific regulatory environment that helped its Islamic finance industry to prosper. In our view, Islamic finance in Africa needs a specific regulatory, disclosure, accounting, and Sharia governance framework to start contributing meaningfully. To date, Morocco seems the only country in the continent that decided to go this route. Although significant challenges for the development of Islamic finance in Morocco remain, the country has made strong advancements through the implementation of specific regulation in 2017.

Chart 3 - Financial Inclusion In Africa



Data as of June 2017.

Sources: Global Findex Database.

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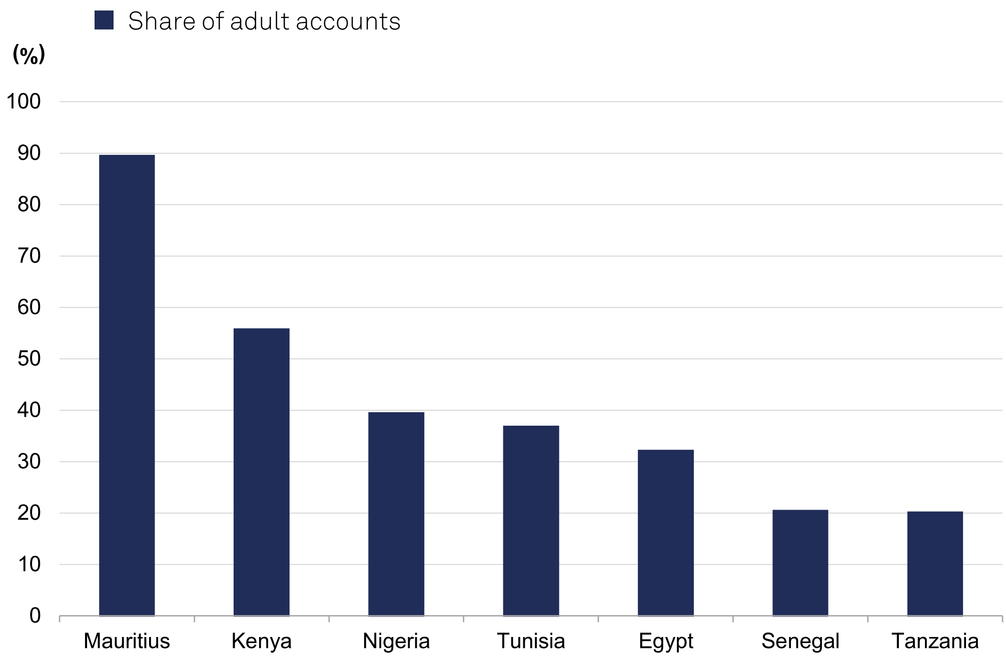

Data as of June 2017.

Sources: Global Findex Database.

Success Will Depend On Ability To Add Economic Value

Regulatory changes could create an enabling environment for the development of Islamic finance in Africa. However, the industry's 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 investors or by offering Islamic products at costs comparable with conventional counterparts. The positive impact of the introduction of Islamic finance on banking penetration is yet to be demonstrated. Although a considerable portion of retail and corporate customers may have a natural bias toward Islamic financial products (specifically for countries with majority Muslim populations), ultimately in our view, the price difference and the quality of service will be a chief determinant. Therefore, we neither foresee a radical change in corporate or consumer behavior if regulators introduce Islamic banking, nor do we expect major strides in banking penetration.

Sovereign issuance of sukuk could help contribute in meeting sizable funding needs and compensate for the lack of other financing alternatives. However, issuers should not see the sukuk market as the panacea for their lack of financing options. The global sukuk market constitutes a negligible fraction of conventional capital markets. It has also its own challenges related to complexity and the significant amount of time and energy necessary to put together a sukuk rather than a conventional bond. Numerous African countries looked at the market in the past few years and decided to walk away because of the complexity of the task. See "Sukuk Are A Natural Fit For Africa, But Not A Simple One," published on Aug 3, 2017.

Only a few made it with the help of multilaterals. However, sukuk could offer an access to an alternative class of investors that would not invest in conventional products. At the same time, these investors channel their funds based on their own risk appetites, which sometime tend to privilege low to moderate risk issuers. Strengthening the credit quality of African nations through economic and financial reforms could help place them on investors' radar.

Multilaterals could also benefit from the opportunities offered by the sukuk market. Issuance of sukuk could help them to free some capacity on their balance sheets. These institutions usually finance long-term infrastructure projects that, once constructed and start to generate income, could serve as underlying assets for sukuk issuance. Such schemes could help alleviate some of the capital constraints faced by few of these institutions. It would also increase their effectiveness in meeting their development role at a time when shareholders are somewhat reluctant to inject additional capital.

Related Research

- The Future Of Banking: Islamic Finance Needs Standardization And FinTech To Boost Growth, April 16, 2018.
- Why The Global Sukuk Market Is Stalling In 2018, June 19, 2018.
- Sukuk Are A Natural Fit For Africa, But Not A Simple One, Aug 3, 2017.

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Islamic Insurers' Net Income Continues To Fall But The Sector Will Stay Profitable In 2018

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In the Gulf Corporation Council (GCC), net income of listed companies in the Islamic (takaful and Islamic cooperative tawuni) insurance sector nearly halved in 2017 to US$375 million, from US$674 million in 2016. The decline in 2017 net income was mainly driven by weaker results in theSaudi Arabian insurance sector and follows an increase in earnings by about 151% in 2016, indicating some considerable earnings volatility in the sector.

In our view, the Islamic insurance sector continues to face secular challenges around relatively concentrated and undifferentiated business models and high expense ratios that leave them susceptible to adverse event risk related to solvency, governance, and accountancy. That said, we believe that medium-term growth prospects in the sector remain satisfactory given relatively low penetration levels, and we expect Islamic insurance to remain profitable overall in 2018. We also observe strengthening capital levels.

Key Takeaways

- We calculate that net income for the Islamic insurance sector in the GCC dropped by about 44% in 2017, with flat GPW growth and a small increase in shareholders' equity.
- Overall, net income in 2017 and first-quarter 2018 declined mainly due to materially weaker results in the Saudi Arabian insurance sector.
- We expect the overall Islamic sector in the GCC to remain profitable this year, but pressure on rates as well as lower consumer spending and challenges to collect VAT for policies written in 2017 and extending into 2018 could result in a further decline in net earnings this year.
- Credit conditions in the industry may weaken, if slow premium growth persists.

Earnings Volatility Remains A Key Challenge For Islamic Insurers In The Region

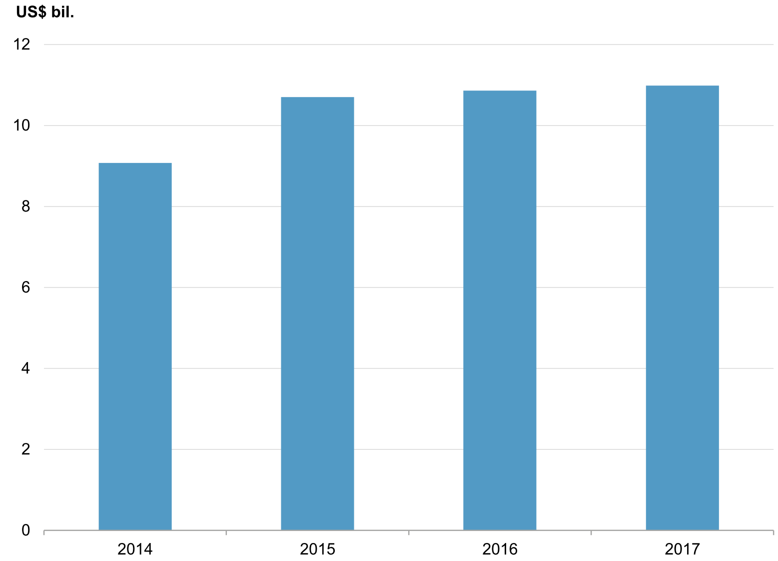
The publicly listed Islamic insurers in the GCC generated an estimated net income of US$375 million in 2017, compared with about US$674 million in 2016 and US$269 million in 2015.

The Saudi Arabian market, which contributes about 85% of total GPW, has been the main source of earnings volatility in recent years. While net income in 2016 grew significantly due to rate increases as a result of stricter application of actuarial pricing, 2017 results dropped materially. This was because of additional reserving needs at the largest insurer, and high bad debt provisions at the fourth-largest insurer (see "Saudi Arabian Insurance Sector Shows 55% Drop In Profits In 2017," published April 18, 2018). First-quarter 2018 also shows a year-on-year drop in net income of 63%, suggesting that this might be another challenging year.

In contrast, the Islamic insurance industry in GCC countries outside Saudi Arabia recorded an increase in net income by about 832% to US$82 million in 2017 from US$9 million in 2016, and an increase of more than 60% in first-quarter 2018 compared with the same period last year. This improvement was mainly driven by better results in the UAE (the second-largest Islamic insurance market in the GCC contributing about 8% of total GPW), as Salama generated a net profit of US$10 million in 2017 against a net loss of US$48 million in 2016. Year-on-year earnings of Islamic insurers in other GCC countries remained broadly flat in 2017.

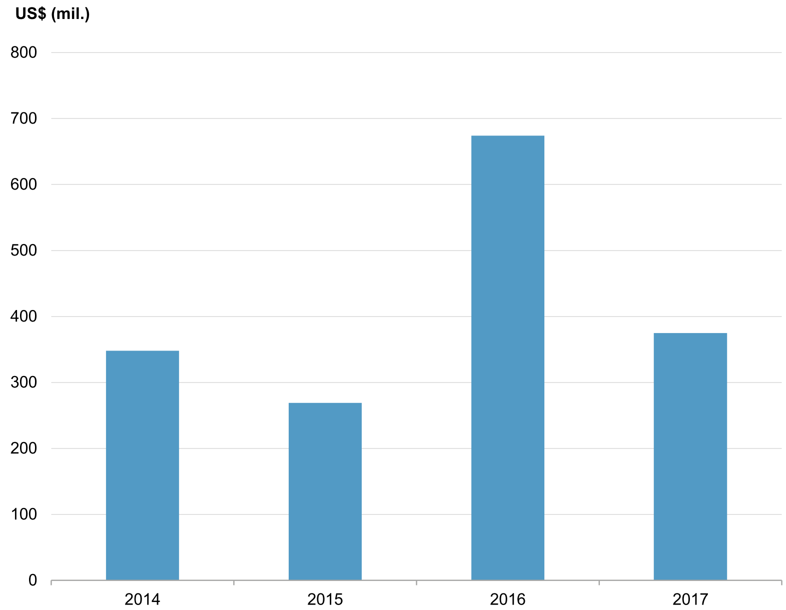
While we expect the Islamic insurance sector in the GCC to remain profitable overall in 2018, there are a number of factors that may affect insurers' profitability in Saudi Arabia and the UAE, and therefore the overall results. First, underwriting profits are lower in Saudi Arabia and the UAE because insurers apply no claims and other discounts to motor policies to gain or maintain market share. Second, insurers in Saudi Arabia have been providing additional coverage under medical policies, which may lead to weaker earnings if this business is not priced adequately. Third, the challenge of collecting value-added tax (VAT) from retail clients for policies written in 2017 and into 2018, as well as new accounting standards leading to higher doubtful debt provisions, could see net earnings decline further this year.

Chart 1 - Gross Written Premiums /Contributions In The Islamic Insurance Industry In The GCC



Source: S&P Global Ratings.

Chart 2 - Net Income In The Islamic Insurance Industry In The GCC



Source: S&P Global Ratings.

Medium-Term Growth Prospects Are Satisfactory Despite Flat Premium Growth In Recent Years

In addition to weaker profitability, GPW growth in the Islamic insurance sector has slowed considerably over the past two years. It stood at slightly below US$11 billion in 2017, having remained flat year-on-year. This was despite moderate growth in some markets outside of Saudi Arabia. For example, Islamic insurers in the UAE recorded premium growth of about 15% in 2017on the back of higher motor rates and an expansion of basic medical insurance coverage in Dubai.

Industry-wide, first-quarter 2018 saw an overall decline in GPW by about 3% compared with first-quarter 2017, driven by a 3.7% drop in GPW in Saudi Arabia during that period mainly because of pressure on rates as well as slower consumer spending following the introduction of VAT in January 2018. The departure of a large number of expats from Saudi Arabia over the past year has also resulted in lower premium income. We anticipate that the local authorities' efforts to tackle the large number of uninsured drivers, combined with the arrival of women drivers in mid-2018 and higher rates for medical business, following the introduction of additional benefits, will support a slight pick-up in premium growth in Saudi Arabia in the medium term. However, this may be offset in the short term by the large number of foreign workers that have already left, or will be leaving in 2018, as Saudization policies are increasingly enforced.

Credit Conditions May Weaken If Slow Premium Growth Persists

Total shareholders' equity in the Islamic insurance sector in the GCC improved by about 3% to US$4.8 billion in 2017, from US$4.6 billion in 2016, as a number of insurers retained parts of their profits or raised additional funds through rights issues. The rate of increase in shareholders' equity exceeds premium growth, which indicates a slight improvement in overall capital adequacy, in our view. However, despite this overall improvement in capital adequacy we still believe there are too many insurance companies in the GCC, and that many of these players lack the scale to operate successfully in overcrowded and highly competitive markets.

We believe that that credit conditions in the sector may weaken over time, if total premium growth remains slow and insurers try to capture market share by further lowering their rates. We also believe that the local regulators, particularly in Saudi Arabia and the UAE, will remain committed to maintaining market discipline by introducing more sophisticated risk-based regulations. This may mean that we will see fewer but more profitable insurers in these markets over time, particularly if smaller and weaker capitalized insurers are not able to cope with all the additional regulatory demands.

Related Research

- Gulf Insurers: The Gap Between Big And Small Insurers Could Widen In 2018, Feb. 14, 2018.
- Saudi Arabian Insurance Sector Shows 55% Drop In Profits In 2017, April 18, 2018.

Only a rating committee may determine a rating action and this report does not constitute a rating action.

Credit FAQ:
Why Gulf Cooperation Council Corporates' Sukuk Issuance Has Dried Up

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Corporate and infrastructure sukuk issuance in the Gulf Cooperation Council (GCC) region was muted in the first half of 2018. In this report, we look at the potential drivers behind the declining regional issuance levels, and our expectations for the remainder of the year.

There are a number of factors at play, including somewhat diminished funding needs, as many GCC corporates continue to operate with relatively limited investment programs. Additionally, in light of regional and international political developments, we believe global investors' perception of the GCC risk has increased over the past 12 months, which has convinced some sukuk issuers to hold off on potential issuance for the time being.

We don't expect this stagnant picture to change much in the second half of the year. Barring any unforeseen large-sized issuance, we expect the 2018 GCC corporate and infrastructure sukuk issuance volumes to remain well below 2017 levels.

How Was Sukuk Issuance Activity In The First Half Of 2018?

While the GCC region's corporate and infrastructure issuers raised over $7.6 billion via sukuk in 2017, issuance was subdued in the first half of 2018. Five issuers raised around $2.6 billion in total, representing a 60% decline relative to the $6.5 billion achieved in the first half of 2017.

Over the past 18 months, the real estate sector dominated the number of issuances, making up 10 of the 16 issuances executed. This is explained by the sector's need for long-term financing amid muted sales and lower risk appetite from the banking system, because of the ongoing real estate price contraction in some GCC countries, particularly, the United Arab Emirates and Qatar.

Table 1 – GCC Corporate Sukuk Issuance In The Past 18 Months

Issuer	Sector	Country	Issuance date	Issuance currency	Size($ mil.)
Damac Real Estate Development Ltd.	Real estate	United Arab Emirates	2Q/2018	USD	400
Emirates	Aviation	United Arab Emirates	1Q/2018	USD	600
Maaden Phosphate Company (MPC)	Mining	Saudi Arabia	1Q/2018	SAR	933
Dar Al Arkan Real Estate Development Company	Real estate	Saudi Arabia	1Q/2018	USD	500
Golden Group Holding LLC	Real estate	Oman	1Q/2018	OMR	130
Emirates REIT	Reale state	United Arab Emirates	4Q/2017	USD	400
Mazoon Electricity Company SAOC	Utilities	Oman	4Q/2017	USD	500
Meraas Holding	Real estate	United Arab Emirates	3Q/2017	USD	200
Meraas Holding	Real estate	United Arab Emirates	2Q/2017	USD	400
Damac Real Estate Development Ltd.	Real estate	United Arab Emirates	2Q/2017	USD	500
Saudi Aramco	Petrochemicals	Saudi Arabia	2Q/2017	SAR	3,000
Dar Al Arkan Real Estate Development Company	Real estate	Saudi Arabia	2Q/2017	USD	500
Ezdan Holding Group Q.S.C.	Real estate	Qatar	2Q/2017	USD	500
Damac Real Estate Development Ltd. Ltd.	Real estate	United Arab Emirates	1Q/2017	USD	125
Equate Petrochemical Company K.S.C.C.	Petrochemicals	Kuwait	1Q/2017	USD	500
Investment Corporation of Dubai	Investment holding	United Arab Emirates	1Q/2017	USD	1,000

Source: Eikon, Bloomberg and S&P Global Ratings. SAR--Saudiriyal. OMR--Omanirial.

What Are The Key Drivers Behind Lower Volumes And Our Expectations For The Full Year?

The landscape remains small and undifferentiated, translating into volatile issuance patterns. While the GCC region has a good number of Islamic banks that are frequent sukuk issuers, the number of corporate issuers that tap into the sukuk space remains small, resulting in volatile annual volumes of issuance. For example, over 50% of the $7.6 billion raised by the region's corporate and infrastructure issuers last year was driven by the activities of two issuers: Saudi Aramco, which raised Saudi riyal (SAR) 11.25 billion (around $3 billion) and Investment Corporation of Dubai, which raised $1 billion (see table 1). We have not seen many similar-sized transactions so far in 2018.

Banks improving liquidity. In 2017 and 2018 to date, we have seen a visible improvement in the liquidity of GCC banks. The stabilization of oil prices, large issuances by select sovereigns that injected the liquidity locally, and muted loan growth explain this trend. Therefore, the banks continue to offer credit at favorable terms to GCC corporates. We do not foresee any major change in this picture over the next 12 months, since we believe that lending growth will remain muted, and local liquidity strong.

Relatively slow corporate capital expenditure programs. Despite stronger oil prices, we believe many GCC corporates remain cautious, translating into muted investment programs in some sectors. Introduction of the value-added tax, energy subsidy reforms, and other government revenue-enhancing initiatives created pressure and uncertainty for some sectors. Additionally, market participants' expectations that global and regional interest rates will continue to normalize at higher levels is also causing issuers to pump the breaks on spending.

International investors' perception of the GCC risk as increasing. Over the past 12 months, there were various global and regional political developments, which we believe reduced international investors' appetite for GCC issuance. These include the recent reinstatement of U.S. sanctions on Iran, the continued animosity between Iran and some of its GCC neighbors, and the boycott of Qatar by a group of Arab states. We also believe that increasing global trade tensions are generally not supportive of emerging capital markets, including the GCC region. Consequently, some issuers that were planning to tap the market in the first half of the year have decided to wait for the dust to clear.

Unresolved issues highlighted by Dana Gas dispute. Although Dana Gas reportedly reached a restructuring deal outside of court with its investors, the dispute acted as a wakeup call that standardization of legal documentation for sukuk issuance and Sharia interpretation is yet to happen. Dana Gas has also highlighted the risks related to enforceability of foreign judgement in emerging markets. We think that this will result in investors paying closer attention to the content of legal documents in the near to medium term and having lower risk appetite for GCC issues.

While the market is talking about a few selective issuances in the second half the year, we still expect to see weaker issuances volumes relative to 2017, barring any unexpected improvement in the global and regional economic outlook.

Related Research

- Why The Global Sukuk Market Is Stalling In 2018, June 19, 2018.
- S&P Global Ratings Raises 2018 Brent And WTI Oil Price Assumptions And 2019 Brent Price Assumptions, May 7, 2018.
- GCC Islamic Banks' Financial Profiles To Stabilize In 2018, April 23, 2018.
- Shining Light On The Key Rating Assumptions For Our Solar Photovoltaic Project Portfolio, April 10, 2018.
- Prospects For GCC Corporate And Infrastructure Sukuk Issuance In 2018 Are Uncertain Despite A Strong Start To 2017, Nov. 13, 2017.

Only a rating committee may determine a rating action and this report does not constitute a rating action.

Issuer Credit Ratings -- Takafuls & Islamic Banks

Issuer	Country	Type	Rating
Al Baraka Banking Group B.S.C.	Bahrain	Bank	BB/Negative/B
Hannover ReTakaful B.S.C.	Bahrain	Insurance	A+/Stable/--
Bank Islam Brunei Darussalam Berhad	Brunei	Bank	A-/Stable/A-2
Jordan Islamic Bank	Jordan	Bank	B+/Stable/B
Wethaq Takaful Insurance Company K.S.C.P.	Kuwait	Insurance	B/ Watch Neg / --
Al Khaleej Takaful Group (Q.P.S.C.)	Qatar	Insurance	BBB/Negative/--
Qatar Islamic Bank (S.A.Q.)	Qatar	Bank	A-/Negative/A-2
Al Rajhi Bank	Saudi Arabia	Bank	BBB+/Stable/A-2
Al Sagr Cooperative Insurance	Saudi Arabia	Insurance	BBB/Stable/--
Islamic Development Bank	Saudi Arabia	Multinational	AAA/Stable/A-1+
Mediterranean & Gulf Cooperative Insurance and Reinsurance Co.	Saudi Arabia	Insurance	B/Stable/--
Saudi Re for Cooperative Reinsurance	Saudi Arabia	Insurance	BBB+/Stable/--
The Company for Cooperative Insurance	Saudi Arabia	Insurance	A-/Stable/--
Wataniya Insurance Company	Saudi Arabia	Insurance	BBB/Stable/--
Islamic Corporation for Development of the Private Sector	Saudi Arabia	Multinational	A+/Stable/--
Al Baraka Turk Katilim Bankasi AS	Turkey	Bank	B/Stable/B
Islamic Arab Insurance Co. (Salama)	UAE	Insurance	BBB-/Negative/--
Sharjah Islamic Bank	UAE	Bank	BBB+/Stable/A-2

Ratings as of August 25, 2017

Sukuk currently rated by S&P Global Ratings

Obligor	Country	Sukuk/Trust certificates	Sector	Date of Rating	Program or Issued ($-eq Mn)
Emirate of Ras Al Khaimah	UAE	RAK Capital	Gov.	2008	2,000
Central Bank of Bahrain	Bahrain	CBB International Sukuk Company (No3)	Gov.	2011	750
Republic of Indonesia	Indonesia	Perusahaan Penerbit SBSN Indonesia II	Gov.	2011	1,250
Government of Malaysia	Malaysia	Wakala Global Sukuk Bhd.	Gov.	2011	800
State of Qatar	QAT	SoQ Sukuk A Q.S.C.	Gov.	2011	4,000
Islamic Development Bank	Saudi A.	IDB Trust Services Ltd.	Gov.	2011	25,000
Republic of Indonesia	Indonesia	Perusahaan Penerbit SBSN Indonesia III	Gov.	2012	25,000
Saudi Electric Co.	Saudi A.	Saudi Electricity Global Sukuk Co.	Corp.	2012	1,250
Majed Al Futtaim	UAE	MAF Sukuk Ltd.	Corp.	2012	1,500
Axiata Group Bhd.	Malaysia	Axiata SPV2 Bhd.	Corp.	2012	1,500
IILM	Malaysia	International Islamic Liquidity Management 2 SA's	SF	2013	3,000
Saudi Electric Co.	Saudi A.	Saudi Electricity Global SUKUK Co. 2	Corp.	2013	2,000
Albaraka Turk Katilim Bankasi AS	Turkey	ABT Sukuk Ltd.	FI	2013	200
Aldar Properties PJSC	UAE	Sukuk Funding (No. 3) Ltd.	Corp.	2013	750
Sharjah Islamic Bank	UAE	SIB Sukuk Co. III Ltd.	FI	2013	1,500

Sukuk currently rated by S&P Global Ratings (continued)

Obligor	Country	Sukuk/Trust certificates	Sector	Date of Rating	Program or Issued ($-eq Mn)
Mumtalakat	Bahrain	Bahrain Mumtalakat Holding Co. Sukuk Programme	Gov.	2014	1,000
Goldman Sachs Group Inc.	Cayman	JANY Sukuk Company Limited	FI	2014	500
Hong Kong (Special Administrative Region)	HK [China]	Hong Kong Sukuk 2014 Ltd.	Gov.	2014	1,000
Luxembourg	Luxembourg	Luxembourg Treasury Securities SA	Gov.	2014	235
Pakistan	Pakistan	The Second Pakistan International Sukuk Company Limited	Gov.	2014	1,000
Ooredoo (Tamweel)	QAT	Ooredoo Tamweel Ltd.	Corp.	2014	2,000
Saudi Electric Co.	Saudi A.	Saudi Electricity Global Sukuk Co. 3 (tranches 1 & 2)	Corp.	2014	2,500
Republic of South Africa	South A.	Republic of South Africa Sukuk 1	Gov.	2014	500
Albaraka Turk Katilim Bankasi AS	Turkey	Bereket Varlik Kiralama A.S.	FI	2014	350
DIFC Investment LLC.	UAE	DIFC Sukuk. Ltd	Corp.	2014	700
Damac Real Estate Development	UAE	Alpha Star Holding Ltd. *(Damac Sukuk)	Corp.	2014	650
Dubai Investment Park Dvt Co LLC	UAE	DIP Sukuk Ltd	Corp.	2014	300
Emaar Malls Group LLC	UAE	Emaar Malls Group Sukuk	Corp.	2014	750
Emaar Properties PJSC	UAE	Emaar Sukuk Ltd.	Corp.	2014	2,000
Emirate of Sharjah	UAE	Sharjah Sukuk Limited	Gov.	2014	750
Hong Kong (Special Administrative Region)	HK [China]	Hong Kong Sukuk 2015 Ltd.	Gov.	2015	1,000
Government of Malaysia	Malaysia	Malaysia Sovereign Sukuk Bhd. (Series 1 & 2)	Gov.	2015	1,500
Petroliam National Berhad	Malaysia	Petronas Global Sukuk	Corp.	2015	1,250
Albaraka Turk Katilim Bankasi AS	Turkey	Albaraka Sukuk Ltd.	FI	2015	250
International Finance Corp.	U.S.A.	IFC Sukuk Co.	Gov.	2015	100
Central Bank of Bahrain	Bahrain	CBB International Sukuk Company (No5)	Gov.	2016	1,000
Government of Malaysia	Malaysia	Malaysia Sukuk Global Berhad	Gov.	2016	1,500
Hilal Services Ltd.	Saudi A.	Hilal Services Ltd.	Gov.	2016	300
Emirate of Sharjah	UAE	Sharjah Sukuk 2 Ltd.	Gov.	2016	500
Ezdan Sukuk Company Ltd.	QAT	Ezdan Sukuk Company Ltd.	Corp.	2016	2,000
Damac Real Estate Development	UAE	Alpha Star Holding III Limited	Corp.	2017	500
Damac Real Estate Development	UAE	Alpha Star Holding IV Limited	Corp.	2017	125
Government of Hong Kong	China	Hong Kong Sukuk 2017 Ltd.	Gov.	2017	1,000
Equate Petrochemical	Kuwait	EQUATE Sukuk SPC Limited	Corp.	2017	2,000
The Saudi British Bank	Saudi A.	SABB Sukuk Ltd.	FI	2017	2,000
Central Bank of Bahrain	Bahrain	CBB International Sukuk Company 6 S.P.C.	Gov.	2017	850
Central Bank of Bahrain	Bahrain	CBB International Sukuk Company 7 S.P.C.	Gov.	2018	850
Damac Real Estate Development	UAE	Alpha Star Holding IV Limited	Corp.	2018	400
Tolkien Funding Sukuk No. 1 PLC	UK	Tolkien Funding Sukuk No. 1 PLC	SF	2018	460
Emirate of Sharjah	UAE	Sharjah Sukuk Programme Limited.	Gov.	2018	1,000

The Five Pillars Of Islamic Finance

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

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

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

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

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

Vocabulary Of Islamic Finance

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

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

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

Halal
Lawful; permitted by Sharia.

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

Haram
Unlawful; prohibited by Sharia.

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

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

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

Investment risk reserve
The amount appropriated by an Islamic financial institution (IFI) from the income of profit sharing investment account (PSIA) holders, after allocating the mudarib's share of the profit or mudarib fee (mudarib refers to the IFI as a manager of the PSIA), to create a cushion against future investment losses for PSIA account holders.

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

Mudaraba
A contract between a capital provider and a mudarib (skilled entrepreneur or managing partner), whereby the Islamic financial institution provides capital to an enterprise or activity to be managed by the mudarib. Profits generated by such an enterprise or activity

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are shared in accordance with the terms of the mudaraba agreement, while losses are borne solely by the capital provider, unless the losses are due to the mudarib's misconduct, negligence, or breach of contractual terms.

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

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

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

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

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

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

Riba
Usury.

Sharia (or Shari'ah)
Islamic law.

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

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

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

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

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

Sources: Islamic Financial Services Board and Standard & Poor's.

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