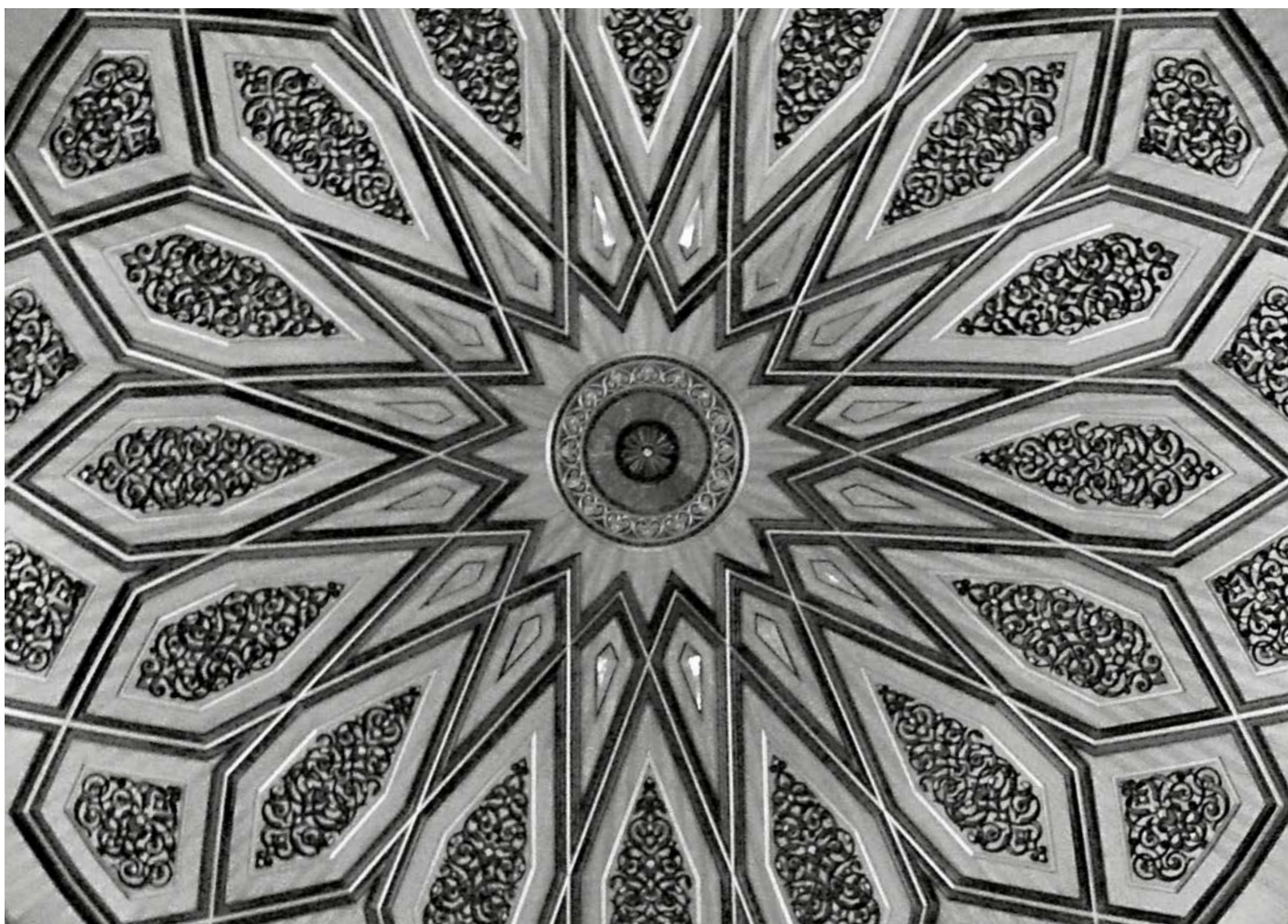


Islamic Finance Outlook

2017 Edition



S&P Global
Ratings

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Islamic Finance 2017: Another difficult year

Dr Mohamed Damak
Global Head of
Islamic Finance

S&P Global Ratings believes that 2017 will be another difficult year for Islamic finance. A few major factors are shaping the industry's growth and trends. On the downside, these include the possible negative impact of policy responses to low oil prices in the industry's core countries, as well as a lack of standardization in a sector that is still a collection of local small industries rather than a truly global industry. Offsetting these negatives are the efforts deployed by major stakeholders to increase the standardization of legal documentation and Sharia interpretation, the continuous interest from an increasing base of customers, the potential contribution of the industry to the financing of the United Nations' Sustainable Development Goals (UN SDGs), and the expected new opportunities created by Iran and other countries looking to tap or return to the sukuk market.

Islamic finance remains concentrated primarily in some oil-exporting countries, with the Gulf Cooperation Council countries, plus Malaysia and Iran, accounting for more than 80% of the industry assets, which we estimate will reach \$2.1 trillion by the end of 2016. The significant drop in oil price, the ensuing significant reduction of core markets' economic growth (with the exception of Malaysia), and the policy responses being implemented in the form of spending cuts, have reduced the growth opportunities for the industry in 2017. We therefore expect banks in core markets to grow more slowly than in the recent past and to somewhat suffer from the shift in their environment. The sukuk market has not played a countercyclical role as an alternative source for governments to close their funding gaps and maintain spending. Rather, conventional debt issuance has been the biggest winner. While this is partly related to the currently low prevailing interest rates, we believe that the length and complexity of the sukuk issuance process still deter some issuers from tapping the market. Finally, despite its small

size and tremendous opportunities to grow, the takaful sector has remained a marginal player in the local and global contexts.

On a positive note, there are some opportunities that could put the industry back on track for strong growth and continued globalization. First, stakeholders are getting more serious and aggressive about standardization. Some players are working on standard legal structures to be used by sovereign issuers to shorten and ease the process of sukuk issuance. We think that if this is achieved, not only will Islamic finance return to its strong growth trajectory, but more innovation will also arise. Second, there is a natural connection between the principles of Islamic finance and some of the UN SDGs. Both of them want to achieve more responsible, equitable, and real-economy-oriented financing. Finally, there are several success stories in Islamic finance and new players can leverage the experience of more advanced ones in their strategy to develop Islamic finance locally.

The Islamic finance industry would benefit from more integration. More sukuk issuance could give takaful operators less risky investment choices, help banks to manage their liquidity, and funds to have some fixed income revenues and invest in profit and loss-sharing instruments. Banks could start to offer takaful products more systematically. Integration is an achievable goal if regulators create a more supportive regulatory environment and scholars and other technical or legal stakeholders work together to achieve standardization. United and more integrated, the industry will grow stronger.

We hope that you enjoy the 2017 edition of our "Annual Outlook For Islamic Finance", and as always, we welcome and encourage your feedback on our research and insights.

الصيرفة الإسلامية في العام 2017: عام آخر صعب

د. محمد ديمق
الرئيس العالمي للصيرفة الإسلامية

تعتقد وكالة "إس أند بي جلوبال" للتصنيفات الائتمانية" بأن العام 2017 سيكون عاماً آخر صعباً على قطاع الصيرفة الإسلامية. تعمل بعض العوامل على تحديد شكل نمو وتوجهات القطاع، والجانب غير الإيجابي لهذه العوامل يتضمن التأثير السلبي المحتمل للإجراءات المتخذة لمواجهة انخفاض أسعار النفط في الدول التي تعتبر أساسية بالنسبة للقطاع، وكذلك عدم توحيد المواصفات في القطاع الذي لا يزال مكوناً من قطاعات محلية ولم يرتق بعد إلى المستوى الذي يؤهله لكي يصبح قطاعاً عالمياً. ما يخفف من هذه السلبيات الجهود المبذولة من قبل المساهمين لتعزيز توحيد الوثائق القانونية وتفسير أحكام الشريعة، والاهتمام المتواصل من قاعدة العملاء المتزايدة، والمساهمة المحتملة للقطاع في تمويل أهداف الأمم المتحدة للتنمية المستدامة، والفرص الجديدة المتوقعة التي ستوفرها إيران والدول الأخرى المتطلعة للاستفادة من أو العودة إلى سوق الصكوك.

يبقى قطاع الصيرفة الإسلامي مركزاً بشكل رئيسي في الدول المُصدرة للنفط، مع دول مجلس التعاون الخليجي، بالإضافة إلى ماليزيا وإيران، ممثلاً أكثر من 80% من أصول القطاع، والتي نتوقع بأن تصل إلى 2.1 ترليون دولار أمريكي بنهاية العام 2016. أدى الانخفاض الكبير في أسعار النفط، وما أعقبه من تراجع كبير في النمو الاقتصادي للأسواق الرئيسية (باستثناء ماليزيا)، والإجراءات المتخذة والتي كانت على شكل خفض للإنفاق، إلى تراجع فرص نمو القطاع في العام 2017. وبالتالي، نتوقع بأن تتباطأ وتيرة النمو لدى البنوك في الأسواق الرئيسية عما هي عليها الآن وبأن تتأثر إلى حد ما نتيجةً للتحويل في ظروفها التشغيلية. لم تؤد سوق الصكوك بعد دورها في مواجهة التقلبات الدورية كمصدر بديل للحكومات لسد ثغرات التمويل لديها والحفاظ على الإنفاق. بدلاً من ذلك، كانت إصدار السندات التقليدية هي الراجح الأكبر. وبينما يرتبط ذلك جريباً بأسعار الفائدة السائدة المنخفضة حالياً، نعتقد بأن طول فترة وتعقيدات عملية إصدار الصكوك لا يزالان العاملان اللذان يعيقان بعض المُصدريين من دخول السوق. أخيراً، بالرغم من حجمه الصغير وفرصه الكبيرة لتحقيق النمو، بقي دور قطاع التكافل متواضعاً على الصعيدين المحلي والعالمي.

من جهة إيجابية، هناك بعض الفرص التي يمكن أن تُسهم في عودة القطاع إلى مساره الصحيح لتحقيق نمو قوي واستمرار توسعه عالمياً. الأولى، أصبح المساهمون أكثر جدية وإقداماً بخصوص توحيد المواصفات، حيث يعمل بعض العملاء على وضع هياكل قانونية موحدة لكي تستخدم من قبل المُصدريين السياديين لتسهيل وتقصير مدة عملية إصدار الصكوك. نعتقد بأنه إذا ما تم إنجاز ذلك فإن قطاع الصيرفة الإسلامية لن يعود إلى مسار النمو القوي فحسب، بل إن ذلك سيؤدي إلى المزيد من الابتكار. والفرصة الثانية فهي وجود ارتباط طبيعي بين مبادئ التمويل الإسلامي وبعض أهداف الأمم المتحدة للتنمية المستدامة. كلاهما يهدف إلى تحقيق تمويل يتسم بالمزيد من المسؤولية والإنصاف وموجهاً نحو الاقتصاد الحقيقي. أخيراً، هناك العديد من قصص النجاح في مجال الصيرفة الإسلامية وبإمكان العملاء الجدد الاستفادة من خبرة العملاء الأكثر تقدماً في استراتيجيتهم لتطوير الصيرفة الإسلامية محلياً.

سيستفيد قطاع الصيرفة الإسلامية من المزيد من التكامل. قد يتيح إصدار المزيد من الصكوك لشركات التكافل خيارات استثمارية أقل مخاطرة، ويساعد البنوك على إدارة السيولة لديها، والصناديق لتحقيق بعض الإيرادات الثابتة والاستثمار في الأدوات التي تنقسم الأرباح والخسائر. يمكن للبنوك البدء في طرح منتجات التكافل بشكل منتظم أكثر. ففي حال عمل المنظّمون على خلق بيئة تنظيمية أكثر دعماً وقام المتخصصون في علم الشريعة والمساهمون الفنيون أو القانونيون الآخرون بالعمل معاً للتوصل إلى توحيد المواصفات. إن توحيد القطاع وتكامله سيحقق نمواً أقوى. نأمل بأن تقضوا وقتاً ممتعاً في مطالعة نسخة العام 2017 من "النظرة المستقبلية السنوية للصيرفة الإسلامية" و نرحب دائماً بملاحظاتكم على أبحاثنا وآرائنا.

Acknowledgement



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

The Islamic economy initiative is supported by the regional and global needs of more than 1.6 billion Muslims. The Islamic finance sector alone continues to grow with over US\$6.7 trillion predicted by 2020. The region has demonstrated dynamic leadership in Islamic finance with significant innovation. With ongoing changes in the global economy, individuals and institutions seeking alternative financial and ethical investments privatisation and transformation programmes, Islamic finance became an important part of our future. Furthermore, today over US\$260 billion is currently invested in Islamic funds and over 300 global Islamic institutions active around the world.

As the region's leading international financial centre and the premier gateway to the \$7.8 trillion Middle East, Africa and South Asian market, DIFC has established a mature ecosystem for all aspects of Islamic Finance, including a range of companies and products across multiple sectors and specialisms.

Our regulatory, legislative and legal frameworks are some of the most advanced in the world allowing multiple activities to take place, of ever increasing scope and complexity, from DIFC. We continue to build on our heritage as a leading Islamic Finance Centre through encouraging further collaboration, knowledge exchange and cooperation on emerging issues in Islamic Finance understanding and practice but also by offering a new domicile for the registration of Islamic collective investment schemes, reflecting an increasing investor preference for Shari'a compliant investment products originating and managed in the region.

Islamic Finance In 2017: Modest Growth Amid Oil-Price Woes

The drop in Islamic finance growth is likely to continue in 2017, in S&P Global Ratings' opinion. While we estimate the industry's total assets will reach \$2.1 trillion at year-end 2016, we think two factors will act as a brake in 2017:

- The impact of policy responses to the decline of oil prices in core markets; and
- The lack of standardization in the industry, which is still made up of a collection of local small industries.

Still, Islamic finance will have the impetus to continue progressing and maintain some growth in 2017, in our view. The subdued but positive economic growth of core markets, the continuous demand from an expanding customer base, a broader consensus around the need to standardize legal structures and Sharia interpretation, and the industry's potential contribution to the United Nation's sustainable development financing goals are likely to help the industry to progress modestly in 2017. If achieved, standardization could put the industry back on track for stronger growth in the coming years. We expect the industry will be worth \$3 trillion sometime in the next decade.

The New Normal For Islamic Finance Core Markets

Islamic finance remains concentrated primarily in oil-exporting countries: The Gulf Cooperation Council (GCC) countries, along with Malaysia and Iran, account for more than 80% of the industry's assets. S&P Global Ratings revised its oil price forecasts in early 2016: We now expect the low oil prices to persist and believe that oil prices will increase only moderately for at least the next two years, averaging \$45 per barrel in 2017 and \$50 in 2018. Given the dependence of core Islamic finance markets on oil, we now expect the economic growth

in some of these markets to remain muted, after having been divided by almost 2.5 times between 2010 and 2016 (see chart 1).

In this environment, Malaysia appears as an outlier, since we expect its GDP growth to stabilize at around 4.7% on average for 2017-2018. The Malaysian economy is more diversified compared with other oil exporting countries (its oil and gas sector represents only around 10% of GDP) and the country's policy response has been sufficient in our opinion to compensate for the lost fiscal revenues related to the drop in oil prices. Malaysia removed oil subsidies in December 2014 and introduced a 6% goods and service tax in April 2015 in preparation for the shift in the global oil price picture.

Iran is also a potential outlier. The market is looking at this country as a potential new

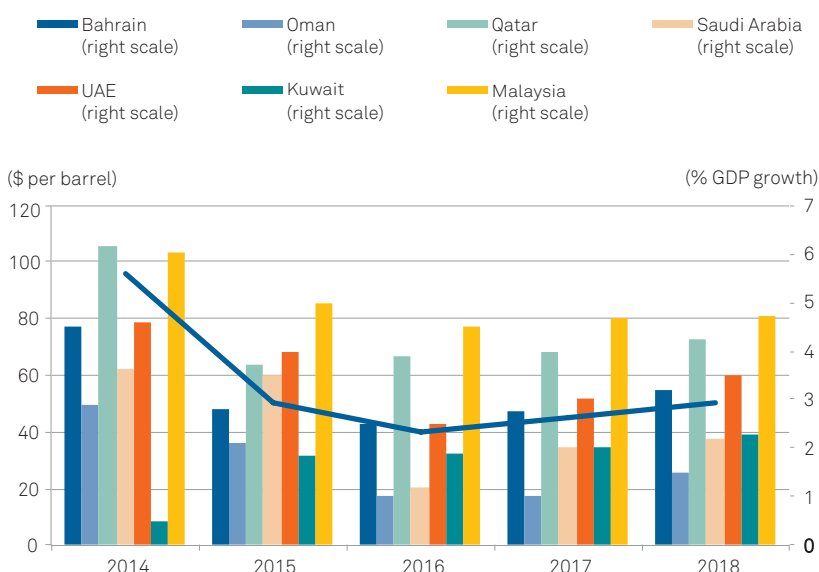
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Chart 1 - Oil Prices And Economic Growth In GCC Countries And Malaysia*



*Average oil price for 2014/2015; S&P Global Ratings' projections for subsequent years. GCC--Gulf Cooperation Council. Source: S&P Global Ratings.

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contributor to a renewed era of growth of the Islamic finance industry. The International Monetary Fund (IMF) projects the country's economic growth at around 4% in 2017-2018. Iran has been under sanctions for more than 35 years and its financing needs are reportedly high. However, we think that Iran will contribute effectively to the growth of the industry only after the remaining sanctions have been removed and its regulatory environment has been brought up to speed. It also remains to be seen whether Iran will attract significant interest from traditional sukuk investors based in the GCC and Asia.

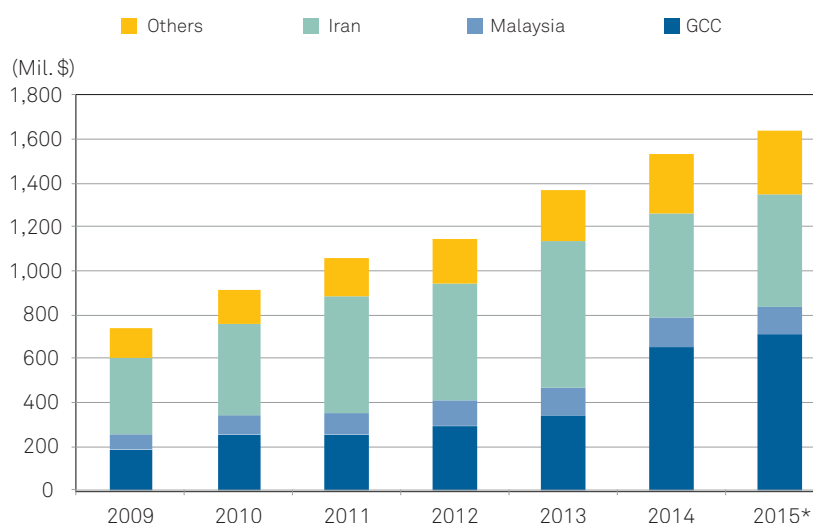
In the meantime, we expect strong policy responses from the GCC countries to adjust to the new normal of oil prices. The extent of fiscal effort these countries have to make in order to balance their budget varies. Bahrain and Oman are the most vulnerable, while Kuwait and Qatar are the least at risk, in our view. While we have seen a policy response materializing in some countries in the GCC, including the United Arab Emirates and Saudi Arabia, in the form of spending cuts, lifting of subsidies, and privatization of government assets, we think the oil price environment will weigh negatively on economic growth in the GCC for the next two years.

What Does This Mean For The Industry?

Islamic banks: Expect a slowdown in growth, deterioration of asset quality, and reduction of profitability

Lower economic growth means lower growth opportunities for Islamic banks. We have seen a decline starting in 2015, when Islamic banks' asset growth fell to around 7% compared with 12% in 2014 (see chart 2). We think this slowdown will persist in 2016 and 2017 with growth stabilizing at around 5%. Lower oil prices mean lower liquidity at Islamic and conventional banks in core markets. Deposits from governments and their related entities account for between 20% and 40% of the deposit base of GCC banks, for example, and this inflow of money depends heavily on oil prices. With the decline in liquidity, the cost of funding for banks has increased. In the same vein, the drop in economic growth

Chart 2 - Islamic Banking Assets 2008-2015



*Iran data as of September 2015. GCC--Gulf Cooperation Council. Source: Central Banks, S&P Global Ratings.

exposed the most vulnerable borrowers, primarily subcontractors and small and midsize enterprises, leading to higher defaults rates and provisioning needs. Overall, we think that not only will banks' asset growth decline, but profitability will also drop, prompting some banks to take a closer look at their efficiency and potentially triggering mergers or acquisitions. The trend started in June 2016, with the announced merger between two conventional banks in Abu Dhabi, First Gulf Bank and National Bank of Abu Dhabi, to create one of the largest financial institutions in the region.

Sukuk market: The market is not playing a countercyclical role

The sukuk market experienced a correction in 2015 when Bank Negara Malaysia (the Malaysian central bank) decided to stop issuing short-term sukuk and switch to other instruments for liquidity management for Islamic financial institutions. The volume of issuance in the first half of 2016 was not that encouraging, particularly if compared with conventional issuance (see chart 3). The market is slowly accepting the evidence that the process of issuing sukuk can be painful and it has become more reticent in issuing such instruments. However, Malaysia is again an

Industry Outlook

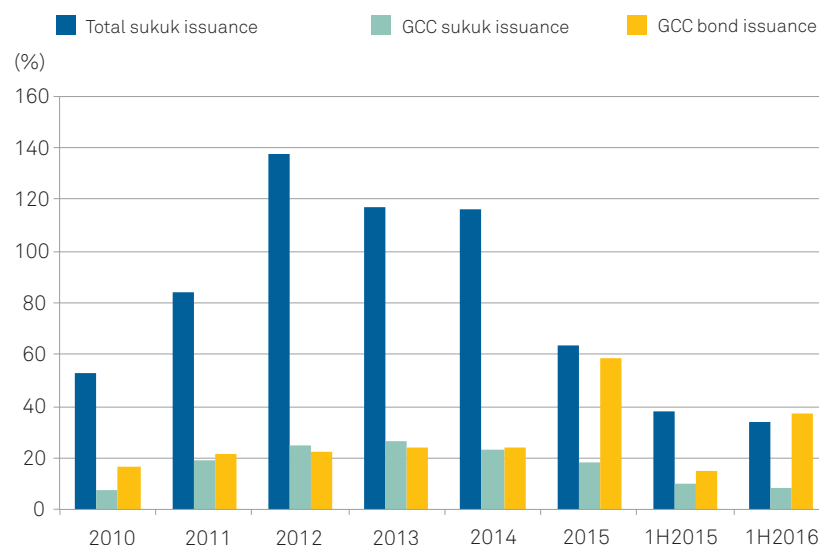
exception to that, where the process for sukuk issuance is as efficient as for conventional bonds, in our understanding. In other countries, however, a government that needs money to pay civil servants or contractors will not ask them to wait for few months until its sukuk is issued. Rather, it will go to the conventional markets. Added to that, local liquidity and global liquidity are contracting for different reasons. Local liquidity, in Islamic finance core markets, depends again on the oil sector, while global liquidity fluctuates in tandem with the policies of the central banks of advanced economies, particularly the Fed and to a lower extent the European Central Bank (ECB).

There is some good news in this not so positive picture, however. The ECB is widely opening the liquidity tap and yields have dropped to historical lows in Europe and developed markets, prompting investors to take another look at emerging markets. Second, Iran could offer growth prospects, assuming the previously mentioned requirements are met. Thirdly, to some extent, new issuers are still looking to tap or return to the market; Senegal and Cote d'Ivoire are examples. Finally, stakeholders are becoming more serious about standardization of structures and Sharia interpretation. Particularly, the Islamic Development Bank Group is working on a solution that could simplify the sukuk issuance process and respond to the lack or fragmentation of sovereign assets.

Takaful sector: Vulnerable to the less-supportive environment and lack of investible assets

The trend is the same for the takaful sector, where we have observed a slowdown in gross contribution growth in 2015 compared with strong growth in the previous year (see chart 4). While we expect this trend to continue in 2016-2017, all other things being equal, we believe that the takaful industry still has ample room for growth if aided by a combination of regulatory push and further development in the other compartments of Islamic finance. Insurance penetration in Islamic finance core markets is still low, with premium to

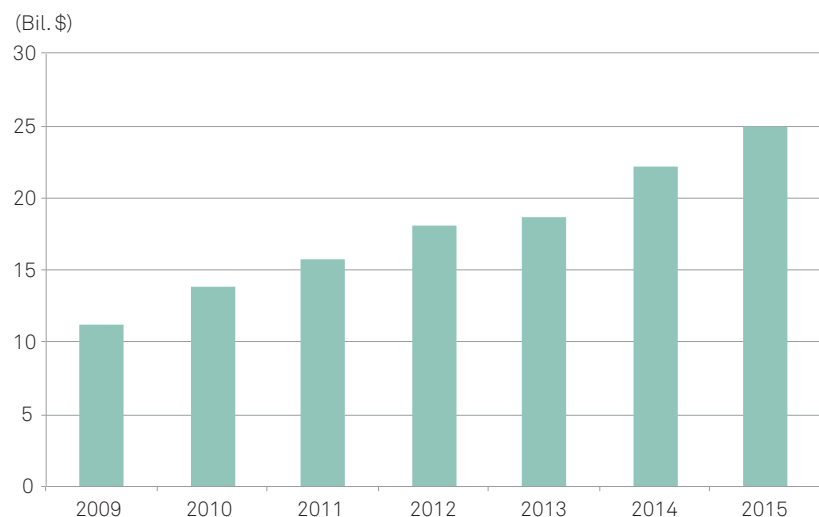
Chart 3 - Total Sukuk Issuance 2010-2016



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

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Chart 4 - Gross Takaful Contributions



Source: Islamic Financial Services Board, S&P Global Ratings' estimates.

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GDP of 1%-2% on average (for the six GCC countries), compared with 8% on average for the developed world. Regulatory actions such as the introduction of compulsory health insurance in the United Arab Emirates, for example, have created some growth opportunities. In our opinion, further revision to the regulatory

Chart 5 - Islamic Finance Core Principles And UN Sustainable Development Goals

Islamic Finance Principles



environment through the introduction of other compulsory insurance could help create new opportunities for the sector. Finally, the implementation of more risk-based regulations in some markets could also help to create stronger takaful operators.

What Could Revive Strong Growth Of Islamic Finance?

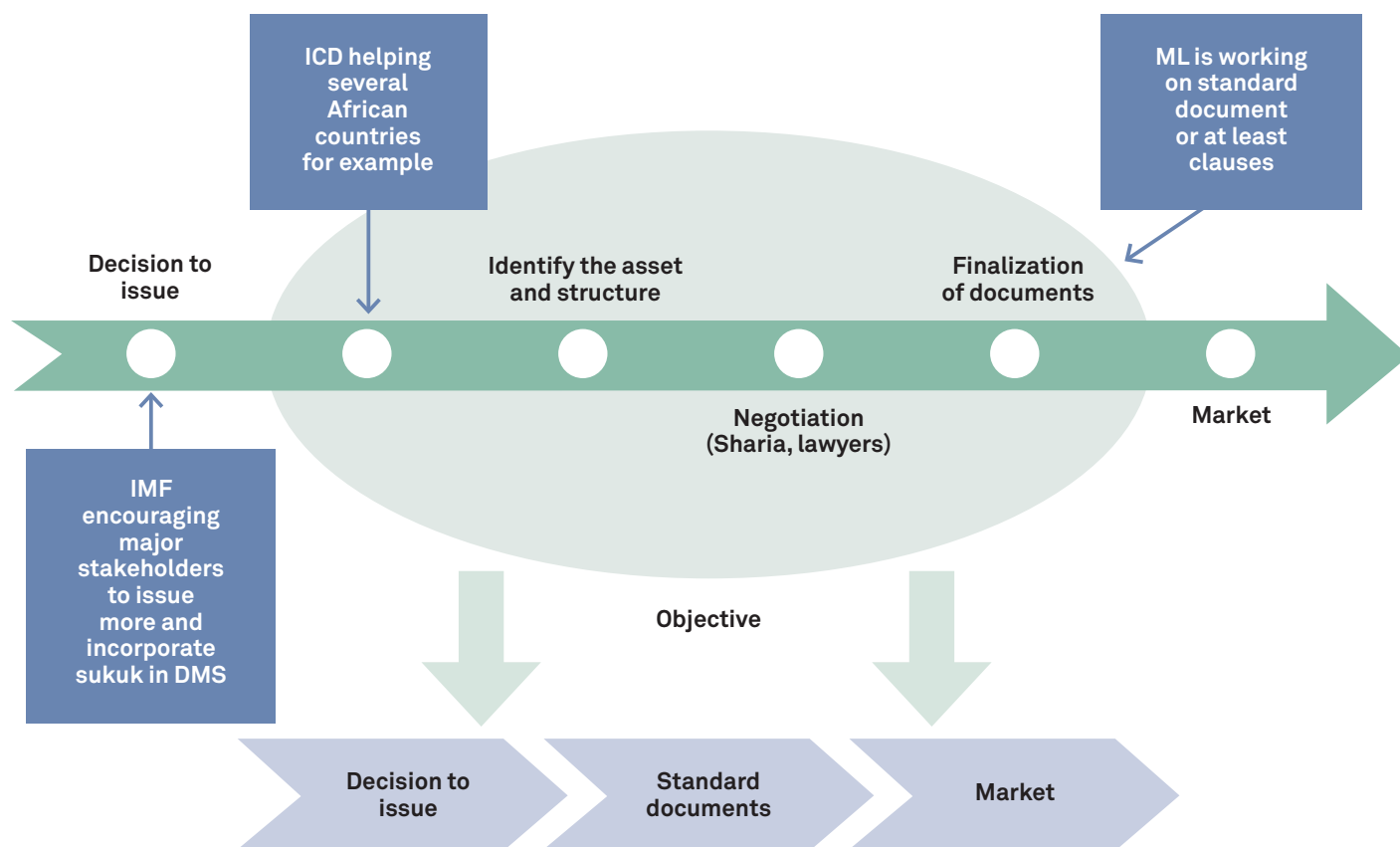
In the current operating environment, S&P Global Ratings sees some opportunities for the future growth of the industry. There are a certain number of prerequisites, however.

The first opportunity lies in the natural connection between the principles of Islamic finance and some of the UN's 17 sustainable development goals (see chart 5). In our view, both aim to achieve more responsible, equitable, and real-economy-oriented financing. A higher involvement of multilateral lending institutions

(MLIs) in Islamic finance through sukuk issuance and Islamic product offerings, on the one hand, and a more stringent application of the principle of profit- and loss-sharing, on the other, could create some future growth opportunities.

The second opportunity lies in the higher involvement of some MLIs in achieving more standardization in legal structures and Sharia interpretation (see chart 6). Some market observers think that the standardization debate belongs to the past. In our opinion, it remains highly relevant. We think that this debate is critical to put the industry back on a strong growth path. MLIs are aiming to show the market how to achieve standardization through the implementation of standard structures, documentation, or steps that issuers should go through to make sukuk issuance easier and more efficient. We also think that if standardization is achieved, stakeholders will

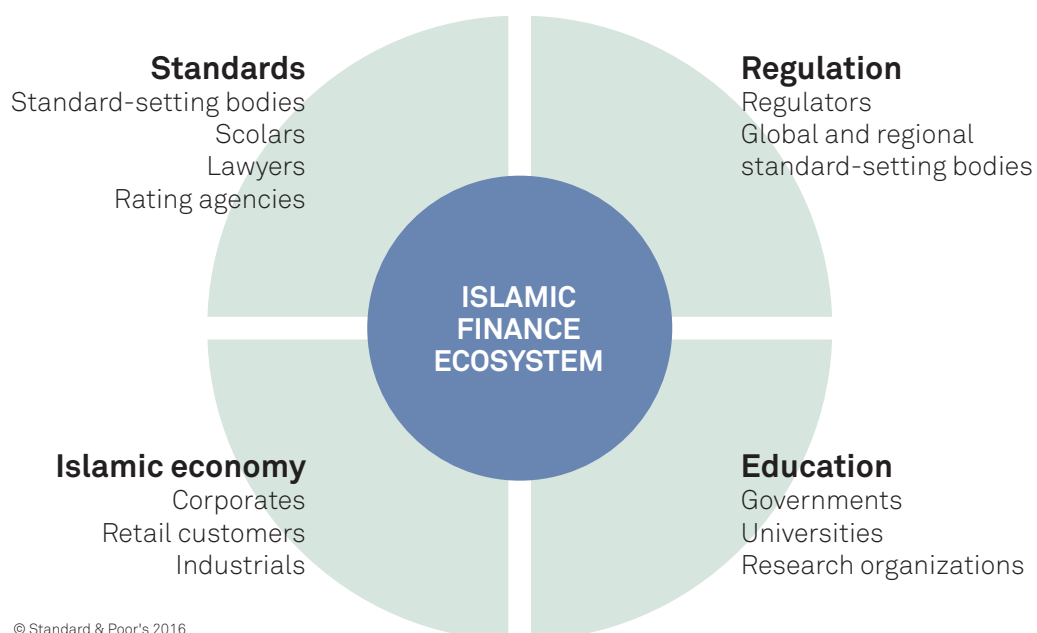
Chart 6 - Standardization Objective



IMF: International Monetary Fund, DMS: Debt Management Strategy, ICD: Islamic Corporation for the Development of the Private Sector
MLIs: Multilateral Lending Institutions

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Chart 7 - Islamic Finance Industry Consolidation



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have more time to devote to innovation and creating new instruments in Islamic finance, which should foster growth.

The third opportunity lies in more consolidation of the industry to transform it into a truly globalized sector from its current status as a collection of small industries (see chart 7). There are several success stories already in Islamic finance. New players could see other market participants' previous successes as motivation. For example, some sukuk issuers could benefit from the experience in Malaysia, where the process of issuing sukuk is as smooth as that for conventional bonds, according to our understanding. Another example could be found in cross-border acquisitions, which might help the industry unite its Sharia interpretation. We have already seen this with several acquisitions of Gulf banks in Turkey, for example. The industry also needs more integration, in our view. For example, more sukuk issuance could help takaful operators to invest less in risky real estate and equities, banks to manage their liquidity, and funds to have some fixed income revenue and allocate other funds to more profit-and-loss sharing instruments. Banks could start to offer takaful products more systematically if the relevant regulation were in place. Progress would be aided if regulators acted to create a more supportive regulatory environment, while scholars, MLIs, and lawyers worked together to achieve standardization. Universities could provide the necessary training and knowledge to create the needed new generation of Islamic finance professionals. Finally, all the sectors that form the Islamic economy could work together to achieve more integration. Overall, united and more integrated, the industry will grow stronger.

Why Low Oil Prices Aren't Sending Sukuk Issuance Skyward

Oil prices have plummeted sharply since mid-2014, putting an end to the commodities super cycle that started a decade ago. S&P Global Ratings expects oil prices will remain substantially below peak levels and stabilize at \$50 per barrel by 2018 and beyond. When prices began to fall, several market commentators predicted a boom in sukuk issuance in 2015 and thereafter, arguing that governments in oil-exporting countries would tap the sukuk market to attract funding and maintain their current and capital spending. However, as we anticipated, the predicted windfall didn't materialize, with total issuance actually dropping compared with last year (see "The Global Sukuk Market: The Correction Is Here to Stay," published Jan. 6, 2016, on RatingsDirect). We continue to believe that sukuk issuance will remain muted over the next 6-18 months for several reasons.

In our view, issuance in the second half of 2016 will continue to depend on monetary policy developments and volatility in developed markets as well as the policy actions of sovereigns in core markets--namely Gulf Cooperation Council (GCC) countries and Malaysia--in response to lower oil prices. While governments affected by the price drop are looking to spending cuts, taxation, and the privatization of state companies to adjust to the new reality, their financing needs remain significant. We think that part of these needs will be met by conventional debt markets and, to a much lesser extent, the sukuk market, with the complexity of sukuk issuance remaining a key deterrent to tapping the market.

Market Activity Remained Subdued In The First Half Of 2016

Despite the significant drop in oil price since mid-2014, total sukuk issuance didn't pick up in 2015 or the first half of 2016, as was predicted by several market commentators. In fact,

issuance actually dropped in the first half of 2016 by 12.5% compared with the same period in 2015 (see Chart 1).

S&P Global Ratings' base-case scenario assumes that sukuk market activity will remain subdued for the remainder of 2016 with total issuance reaching around \$50 billion-\$55 billion for the full year 2016 compared with \$63.5 billion in 2015. We expect this to be the case for several reasons:

The negative correlation between oil prices and sukuk issuance is a myth

As with conventional capital market issuance, the size and frequency of sovereign sukuk issuance increased alongside oil prices from 2009 to 2014, albeit at a much more subdued rate. A simple correlation coefficient between Brent spot prices and monthly sukuk issuance volume shows a relationship of just 0.16 for

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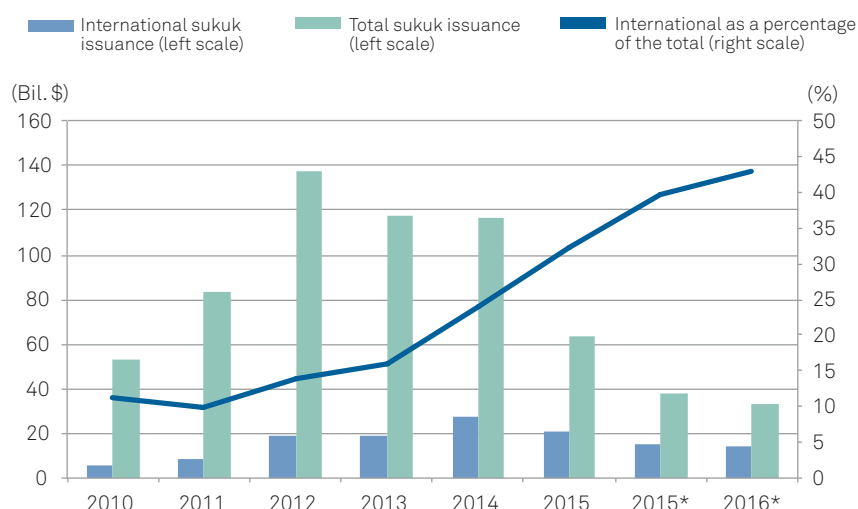
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Chart 1 - International And Total Sukuk Issuance 2010-2016*



*As of June 30.

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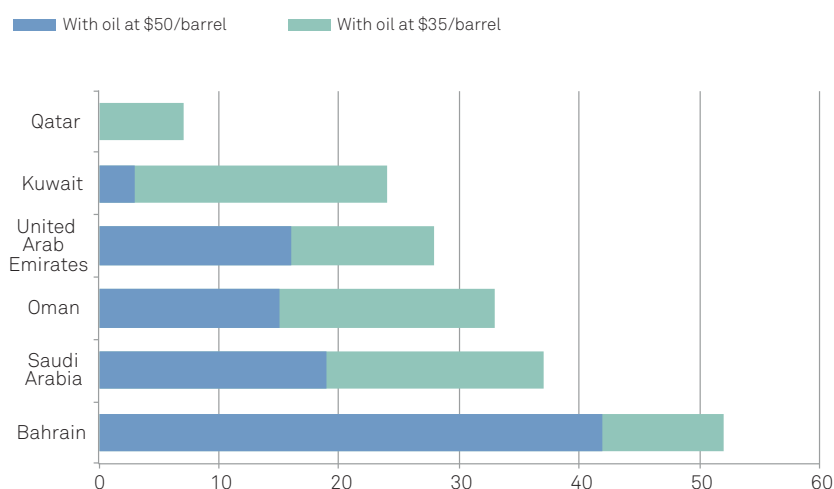
Middle Eastern sovereign issuers. We note that the development and depth of debt capital markets is also an important consideration when interpreting this data. For instance, sukuk issuance has risen, but from a small and shallow base, which in part explains the volatility in this type of issuance. In our opinion, one of the principal reasons explaining the lack of linkages between oil prices and sukuk issuance is the large stocks of fiscal assets that many GCC countries have built up through years of fiscal and current account surpluses. Along with conventional debt issuance, governments are now using these assets as a source of public-sector deficit financing (or for infrastructure projects). Instead, the broader rationale behind GCC sovereign sukuk issuance thus far, including that of central banks, has been for project financing, for benchmarking, or to offer liquidity-management instruments to local Islamic banks. Bahrain and Oman have been exceptions in the GCC as more active issuers of sukuk and conventional bonds due to the smaller size of their reserves and the significantly higher fiscal breakeven oil price for their respective budgets.

Policy response impacts are starting to show

In response to sinking oil prices, GCC governments are introducing a mix of spending cuts and revenue-boosting initiatives to reduce their fiscal deficits and the speed of external asset burning. The reduction of energy subsidies, revaluation and reprioritization of current and capital spending, discontinuation of projects are among the strategies used by some GCC countries to adjust to the new oil price norm. Additional measures such as a tax introduction (VAT is likely to be introduced in the GCC by 2018-2019) or partial privatization of state companies (Aramco for example) are in the pipe.

A recent study by the International Monetary Fund (IMF) shows that some GCC countries will have to cut spending by significantly more than others to balance their budget with an oil price of \$50 per barrel (see Chart 2). For Kuwait, this is less than 5%, while it would be more than 40% for Bahrain.

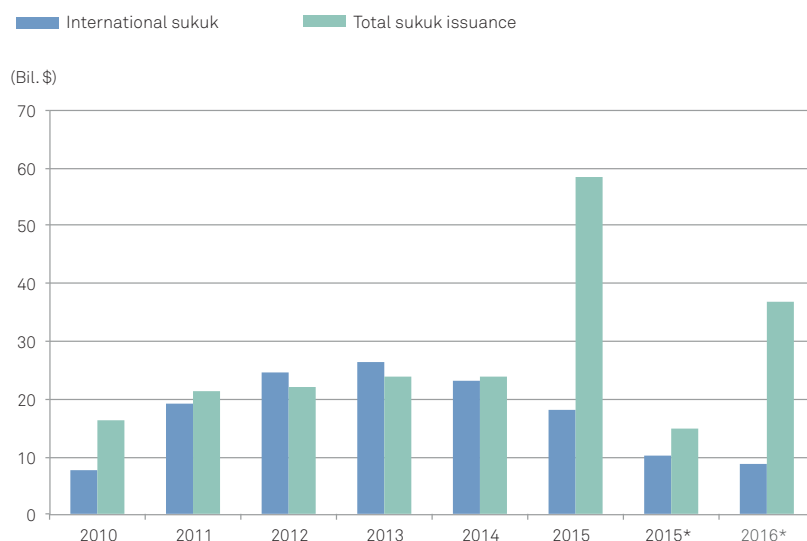
Chart 2 - Spending Cuts To Balance Budget



Estimate based on International Monetary Fund graph.

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Chart 3 - Sukuk Versus Bond Issuance In the Gulf Cooperation Countries



*As of June 30.

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The exact deficit financing mix in our assumptions differs by sovereign, but on average, we expect GCC countries to finance their deficits using a mix of their assets and conventional debt/sukuk issuance. We also think that sovereigns will rely more heavily on conventional issuance. In the first

half of 2016, total conventional debt issuance (in the GCC) increased by 148.2% compared with the same period in 2015, while sukuk issuance dropped by 15.2% over the same period. Most of the growth in conventional issuance is explained by Saudi Arabian and Abu Dhabi bond issuance (see Chart 3).

The complexity of sukuk issuance deters market activity

One of the reasons why sukuk issuance in the GCC is dropping while conventional issuance is booming is related to the difficulties inherent to sukuk issuance (see Chart 4). While some commentators in the market believe that this debate belongs to the past, we continue to see this as an important issue. Today, it is still more time consuming and complex to tap the sukuk market than issue a conventional bond. The time and cost gap has reduced but is still there.

On a positive note, several heavy weights in the financial industry are pushing the market toward more standardization, and preparing it for greater innovation and accelerated growth. The IMF advised GCC governments to integrate sukuk issuance in their debt-management strategies. The Islamic Development Bank (IDB) and the Accounting and Auditing Organization for the Islamic Financial Institutions (AOIFI) are working separately on introducing more standardization to the legal documentation. The IDB is also working on a new structure that could, if implemented, simplify the sukuk issuance process. In our opinion, standardization could help the market in two ways: On the one hand, it will restore the attractiveness of sukuks for new and existing players. On the other hand, it will free up the capacity of market participants to develop new Islamic financing products that cater to the opportunities created by the regulatory changes in the global financial system (through higher profit and loss sharing) and the sustainable development agenda (through products for the financing of infrastructure).

Iran could be a game-changer but only in the medium term

Market participants are looking at Iran to turn up sukuk market activity, because of the significant size of the country's investment needs. We think that the Iranian banking system and government resources alone cannot fulfill these needs. Therefore, we expect that some investment will find its way to the sukuk market, assuming that Iran makes the necessary regulatory adjustments and, more importantly, all sanctions are lifted. However, we are of the view that this will take some time to materialize and translate into meaningful market activity. Besides Iran, we also expect to see some returning issuers (Indonesia, Hong Kong, Luxembourg, etc.) and a few new issuers, such as, Tunisia, which is currently going through the phase of market education as it tries to counter the perception that sukuk issuance is the same as privatizing state assets.

Other important factors

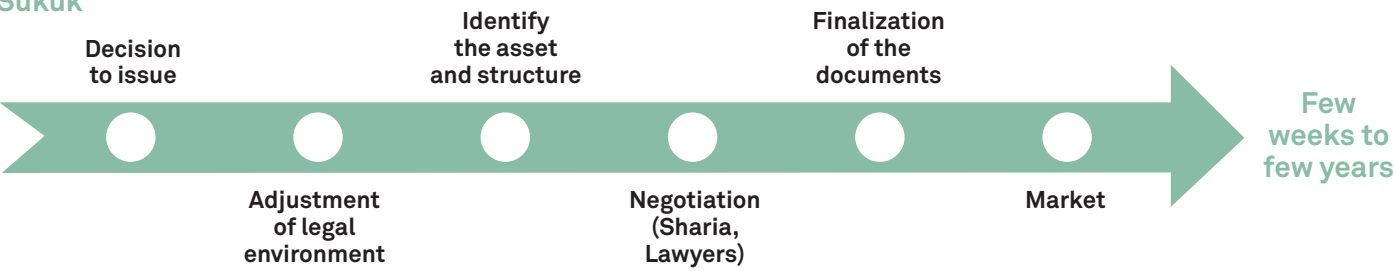
We believe that the future direction of monetary policy and the recent episodes of volatility in advanced markets will also play a role in shaping future sukuk market activity. Rate increases by the U.S. Federal Reserve will result in a drop in global liquidity that will ineluctably reduce global investor appetite for sukuk and push up prices. Similarly, significant volatility in the international capital markets, such as the one we have seen following the U.K.'s referendum to leave the European Union (Brexit), could cause significant delays in issuances be it Islamic or conventional. Some market participants tend to forget that the sukuk market is just a component of the global capital markets and that U.S. and European investors are still major sukuk investors. At the same time, we are of the view that the market could benefit from the European Central Bank's (ECB) quantitative easing. Yields have been low or even negative for prolonged periods across Europe. As the ECB has opened widely liquidity taps to fight the deflationary pressures, we think that some investors are actively looking at emerging market instruments for better yields and believe that the sukuk market will benefit from that.

Chart 4 – Sukuk Verses Conventional Bond Issuance

Bond



Sukuk



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Presale: Ezdan Sukuk Company Ltd.

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Profile

US\$2 billion sukuk trust certificates program:
assigned 'BBB-' rating

Transaction Summary

Ezdan Sukuk Company Ltd. (Ezdan Sukuk), a trustee incorporated in Qatar, plans to establish a US\$2 billion sukuk (trust certificates) program that will be used by Ezdan Holding Group Q.S.C. (Ezdan) to repay existing bank debt and fund general corporate needs.

The proposed sukuk issuance shall be made via a Wakala contract that comprises two legs: a Murabaha contract and a sale and purchase agreement of real estate assets. We understand that Ezdan is using this structure to raise funds in compliance with Sharia law. The underlying Wakala assets will be real estate assets located in Qatar, specifically in Doha and Wakra, owned by Ezdan (not less than 51% of the principal) and commodities (up to 49% of the principal). Under the transaction, Ezdan will sell the interest related to the pool of assets to Ezdan Sukuk.

Under the proposed trust certificate program, Ezdan has the obligation to:

- Collect the Wakala assets revenues that will underpin the periodic distribution amount payment. These revenues will come from the rental of the underlying real estate assets and the profit portion of the Murabaha contract. In case of shortfall, Ezdan has an option to provide an interest free funding to the issuer from its own funds or externally. If not,

we expect this shortfall to trigger the early dissolution of the sukuk.

- Pay the exercise price, in case of scheduled dissolution or early dissolution following the occurrence of a dissolution event, which will equal the U.S.-dollar amount outstanding face value of the certificates on the dissolution date less the Murabaha deferred sale price (which will be paid through the Murabaha agreement), in addition to accrued and unpaid periodic distribution amounts, plus any amount repayable under the liquidity facility provided or not by Ezdan.

Rationale

The rating on the sukuk reflects the rating on Ezdan (BBB-/Stable/--), because the proposed transaction fulfills the five conditions of our criteria for rating sukuk (see "Methodology For Rating Sukuk," published Jan. 19, 2015, on RatingsDirect):

- Ezdan will provide sufficient and timely contractual obligations for the repayment of the principal amount and the final periodic distribution amount in case of shortfall in the performance of the underlying assets leading to an early dissolution of the sukuk. It is worth mentioning that while the deferred sale price related to the Murabaha leg of the sukuk is not clearly defined in the document, we understand that it will be calibrated to match the principal amount (up to 49%) and the periodic distribution amounts related to the Murabaha leg. Such condition is crucial to the rating and

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if not fulfilled might result in a negative rating action or withdrawal of the rating.

- Ezdan's obligations under the sukuk terms and conditions are irrevocable.
- These obligations will rank pari passu with Ezdan's other senior unsecured financial obligations.
- Ezdan will undertake to cover all the costs related to the transaction, through the service agency agreement and the exercise price payable for the benefit of Ezdan Sukuk.
- Although the documentation mentions a risk of a total loss event (TLE), we view as remote that such a risk would jeopardize the full and timely repayment of the sukuk. Our opinion is underpinned by our understanding that the portfolio of underlying assets will be made of diversified portfolio of real estate assets located in Qatar (for at least 51% of the underlying assets). Ezdan's legal obligations under the sukuk terms and conditions might leave investors exposed to residual assets risks. Ezdan has the obligation to ensure that the assets are covered by insurance and also the obligation 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.

We therefore equalize the rating on the sukuk with the long-term corporate credit rating on Ezdan. The rating on the sukuk transaction is based on draft documentation received as of April 17, 2016. Should final documentation differ substantially from the draft version, we could change the rating on the sukuk.

This report does not constitute a recommendation to buy, hold, or sell the certificates. Standard & Poor's neither structures sukuk transactions, nor provides opinions with regard to compliance of the proposed transaction with Sharia.

Table 1 - Ezdan Sukuk Company Ltd. Transaction Details

| | |
|--|---|
| Issuer, trustee | Ezdan Sukuk Company Ltd., incorporated in Qatar |
| Seller of the assets | Ezdan Holding Group Q.S.C. |
| Servicing agent, buyer and seller of the underlying assets | Ezdan Holding Group Q.S.C. |
| Periodic distribution profit rate | Annual fixed or floating profit rate, determined at the closing of the transaction. |
| Joint lead managers | HSBC Bank plc and Mashreqbank P.S.C |
| Principal paying agent | Citibank N.A., London branch |
| Governing law | English law |

The sukuk structure provides sufficient contractual obligations for full and timely repayment

The transaction involves a special-purpose company incorporated in Qatar, issuing rated sukuk trust certificates. The proceeds of the sukuk will be used to acquire a portfolio of Sharia compliant assets to be managed by Ezdan (as service agent). On the sukuk's closing date, Ezdan Sukuk will buy interest related to a portfolio of real estate assets from Ezdan (for at least 51% of the principal) and commodities (up to 49% of the principal, referred to as Murabaha assets thereafter).

Periodic distribution payments

Under the proposed sukuk's terms and conditions, the revenues generated by the underlying assets (leases for the real estate assets and the profit component of the deferred sale price for the Murabaha assets) will serve to pay the periodic and principal distribution amounts on the sukuk (see chart). In case of shortfall between the revenues generated by the underlying assets and the periodic distribution amount, Ezdan, among other options, can provide liquidity support. While legally Ezdan is not obliged to provide such support, we assume that failure to do so would result in the early dissolution of the sukuk.

Principal repayment

At the maturity date of the transaction or upon the occurrence of an early dissolution event (the

definition of which excludes total loss events), Ezdan, under the purchase undertaking, will buy the real estate underlying assets at an exercise price that is equivalent to the aggregate face amount of the certificated outstanding less the Murabaha deferred sale price (which will be paid through the Murabaha agreement), all accrued but unpaid periodic distribution amounts, an amount equal to the outstanding liquidity support amount if provided, and any amount payable by the trustee under the transaction documents. The execution of the purchase undertaking and the Murabaha agreement will allow the issuer to receive the full amount necessary for the final redemption or for the redemption in case of the occurrence of an early dissolution event. We acknowledge that while the deferred sale price related to the Murabaha leg of the sukuk is not clearly defined in the document, we understand that it will be calibrated to match the principal amount (up to 49%) and the periodic distribution amounts related to the Murabaha leg. Such condition is crucial to the rating and if not fulfilled might result in the assignment of a different rating or a withdrawal of the rating.

Status

All Ezdan's obligations under the transaction documents are irrevocable, senior unsecured, and will rank pari passu with all of Ezdan's other senior unsecured financial obligations.

We see only minor structural subordination of the sukuk certificates to Ezdan's existing secured notes. This is because the vast majority of its total net operating income (63%) is generated by

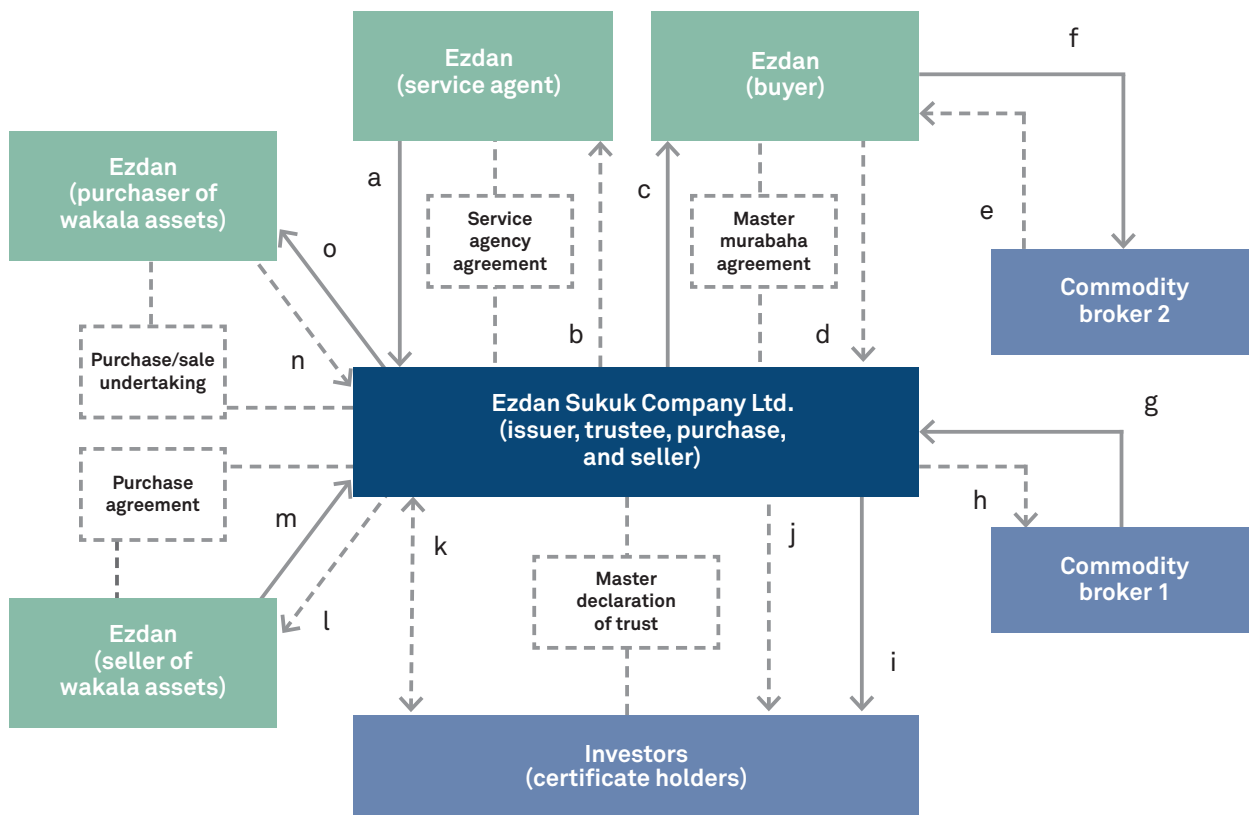
unencumbered assets and is well above our 50% threshold for notching a rated issuance. Ezdan will also undertake to cover all the costs related to the transaction through the service agency agreement and the exercise price of the purchase agreement for the benefit of Ezdan Sukuk.

Total Loss Event

Although 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. Our opinion is underpinned by our understanding that the portfolio of underlying assets will be made of diversified portfolio of real estate assets located in Qatar (for at least 51% of the underlying assets). Ezdan's legal obligations under the sukuk terms and conditions might leave investors exposed to residual assets risks. Ezdan has the obligation to ensure that the assets are covered by insurance, in addition to the obligation to make up any shortfall between insurance proceeds and the principal amount, under a TLE scenario, unless it proves beyond any doubt that it has complied with its insurance obligations. Nevertheless, we consider the likelihood of a TLE occurring as remote.

Our rating on Ezdan is supported by our view of the company's large and diversified income-producing real estate asset portfolio that generates stable cash flows, the substantial value from its equity investments portfolio and its moderate exposure to more risky development activities. For more details, see "Qatari Real Estate Company Ezdan Holding Group Assigned 'BBB-' Rating; Outlook Stable," published April 26, 2016.

Chart 1 - Ezdan Sukuk Company Ltd. Payment Distributions And Principal Repayment



Legend:

- a Management of wakala portfolio (incl. wakala portfolio revenues)
- b Incentive fee
- c Sale of commodities
- d Deferred sale price
- e Proceeds from the sale of commodities
- f Sale of commodities
- g Purchase of commodities
- h Cost price for purchase of commodities
- i Issue of certificates
- j Periodic distribution amounts and dissolution amounts
- k Issue proceeds
- l Purchase price
- m Sale of real estate assets
- n Exercise price
- o Sale of real estate assets
- > Cash movement
- > Noncash movement

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This presale report is based on information as of April 7, 2016. The ratings shown are preliminary. This report does not constitute a recommendation to buy, hold, or sell securities. Subsequent information may result in the assignment of final ratings that differ from the preliminary ratings.

Profile

U.S. Dollar Sukuk Trust Certificates: Rated 'A-'

Transaction Summary

This presale report is based on information dated April 7, 2016, and is posted in conjunction with the planned issuance of up to US\$1.5 billion sukuk (trust certificates) by Malaysia Sukuk Global Berhad, a financing vehicle for the government of Malaysia (foreign currency A-/Stable/A-2; local currency A/Stable/A-1; axAAA/axA-1+). Malaysia Sukuk Global Berhad will enter into a voucher purchase agreement (for no less than 80% of the issue proceeds), share sale and purchase agreement (for up to 20% of the issue proceeds), a purchase undertaking, and a wakala agreement with the government of Malaysia. If the transaction's underlying assets were to be substituted with lease assets, the issuer will also enter into a lease agreement with the government of Malaysia.

Rationale

The rating on the sukuk reflects the foreign currency sovereign credit rating on Malaysia because the transaction fulfills the five conditions of our criteria for rating sukuk (see related criteria section):

- Malaysia will provide sufficient and timely contractual obligations for the payment of the periodic distribution amounts (through the wakala agreement where the transaction's underlying assets are made up of vouchers and/or the lease agreement if there are lease assets) and the principal amount (through the purchase undertaking of the sukuk assets);

- These obligations are irrevocable;
- These obligations will rank pari passu with Malaysia's general obligations;
- Under the agency agreement, Malaysia will undertake to cover all the costs related to the transaction; and
- We assess as remote the risks that a total loss event jeopardizes the full and timely repayments of the sukuk. Our opinion is based on the unconditional obligations of Malaysia to make up any shortfall between the insurance proceeds (if any) and the principal repayment of the sukuk under a total loss event scenario.

Under our criteria, the sukuk rating is therefore equalized with the foreign currency issuer credit rating on Malaysia. The rating on the sukuk transaction is preliminary and based on draft documentation. Should final documentation differ substantially from the draft version, the rating on the sukuk could be changed. This report does not constitute a recommendation to buy, hold, or sell the certificates. Standard & Poor's neither structures sukuk transactions nor provides opinions with regards to compliance of the proposed transaction with Sharia.

A Wakala Sukuk Comprising Sufficient Contractual Obligations For Full And Timely Repayment

The transaction involves a special-purpose company incorporated in Malaysia, issuing rated sukuk trust certificates. The proceeds of the sukuk will ultimately be used to acquire a

pool of underlying assets, including vouchers (at least 80% of the sukuk proceeds) and shares (not more than 20% of the sukuk proceeds) to be managed by the government of Malaysia (the wakeel). The vouchers will represent entitlements to a specified number of travel units, while the shares would be Sharia-compliant shares. Under the sukuk terms and conditions, the proceeds from the sale of vouchers and/or rental where the sukuk assets comprise lease assets, shall be sufficient to pay the periodic distribution amount. In case of shortfall between the vouchers sale proceeds and the periodic distribution amount, the Malaysian government has irrevocably undertaken to make up this shortfall. The government as lessee will also pay the rental related to the leasing assets if any (see chart 1).

The government of Malaysia, as wakeel, will pay the necessary amount in a timely manner to allow the issuer to pay the periodic distributions to the sukuk holders. These obligations are unconditional and will rank pari passu with Malaysia's other general obligations.

At the maturity date of the transaction or upon the occurrence of a dissolution event, Malaysia will buy back the Wakala sukuk assets (vouchers, lease assets [if any] and shares) for a price equivalent to the sum of the following: principal amount of the sukuk; all accrued and unpaid periodic distribution amounts; any accrued and unpaid wakala service charge amount; and any unpaid expenses related to the transaction (see chart 2). The execution of this undertaking will allow the issuer to receive sufficient amount to pay back the investors on the scheduled maturity date or upon the occurrence of a dissolution event.

All the obligations of Malaysia under the purchase undertaking are irrevocable, and will rank pari passu with all other general obligations of Malaysia. Malaysia will also cover all the costs related to the transaction through the agency agreement.

Total Loss Event

While a total loss event risk is mentioned in the documentation of the sukuk (specifically for

the leasing assets), we assess as remote the possibility that a total loss event jeopardizing the full and timely repayments of the sukuk could occur. Our opinion is based on the unconditional obligations of Malaysia to make up any shortfall between the insurance proceeds and the principal repayment of the sukuk under a total loss event scenario.

Chart 1 - Malaysia Sukuk Global Berhad - Periodic Distributions

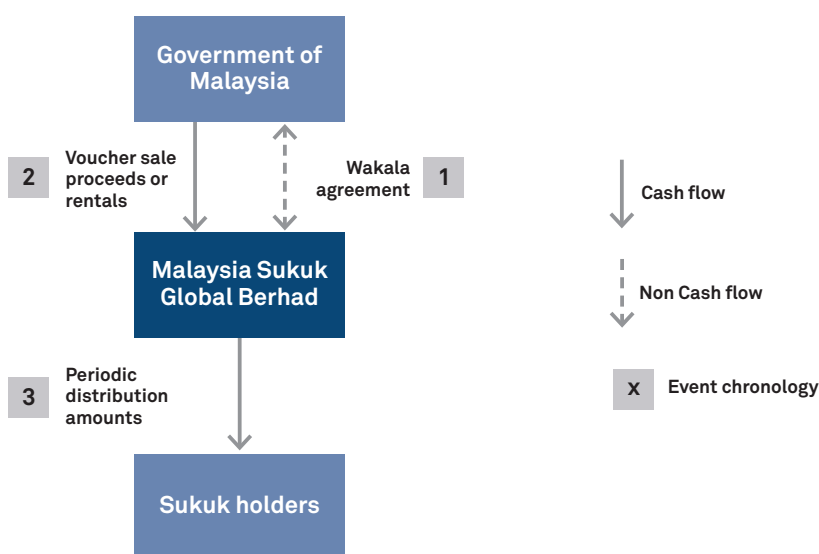
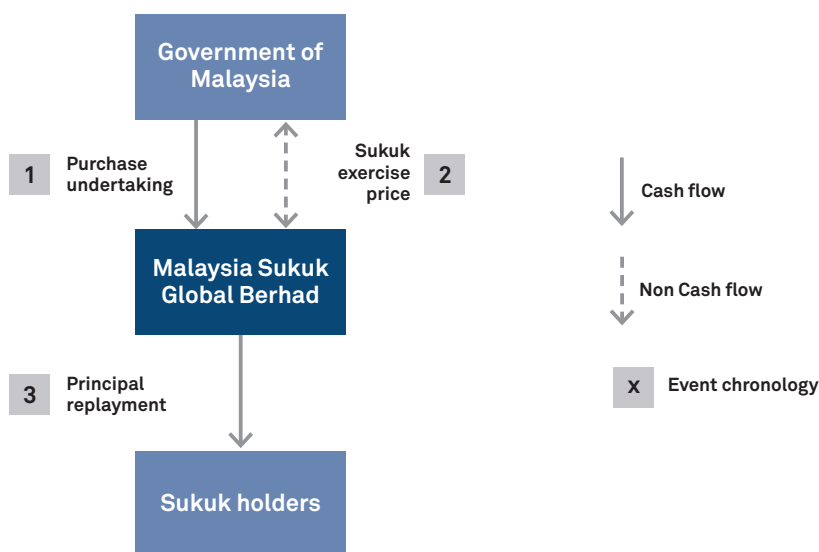


Chart 2 - Malaysia Sukuk Global Berhad - Periodic Repayment



Presale: Sharjah Sukuk 2 Ltd. (Emirate of Sharjah)

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Profile

Sukuk trust certificates: assigned preliminary 'A' rating

Transaction Summary

Standard & Poor's Ratings Services is publishing this presale report in conjunction with the planned issuance of sukuk (trust certificates) by Sharjah Sukuk 2 Ltd., a trustee incorporated in the Cayman Islands, wholly owned by the Emirate of Sharjah (A/Stable/A-1), which will enter into, among other contracts, a leasing and purchase undertaking agreement with the Emirate of Sharjah. Under the leasing agreement, the sukuk underlying assets will be leased to the government of Sharjah at a pre-determined rent calibrated to match the periodic distribution amount on the sukuk and any other costs related to the transaction. Under the purchase undertaking, the government of Sharjah will, at the maturity of the sukuk or in case of early dissolution, purchase the underlying assets at an exercise price matching the sukuk principal, any accrued and not paid periodic distribution amount, and any other expense. These obligations are unconditional and will rank pari passu with Sharjah's other financial obligations.

- Sharjah, through the ijara agreement and the purchase undertaking, will provide sufficient and timely contractual obligations for the repayment of the periodic distribution amounts and the principal amount of the sukuk;
- Sharjah's obligations under the sukuk terms and conditions are irrevocable;
- These obligations will rank pari passu with Sharjah's other financial obligations;
- Sharjah will undertake to cover all the costs related to the transaction, through the supplementary rental in the ijara agreement;
- We assess as remote the risks that a total loss event jeopardizes the full and timely repayments of the sukuk trust certificates. Our opinion is based on Sharjah's unconditional obligations to make up any shortfall between the insurance proceeds (if any) and the full reinstatement value (defined as the outstanding face amount of the sukuk together with the periodic distribution amount payable for a 30-day period) under a total loss event scenario on the 31st day following a total loss event.

Rationale

The rating on the sukuk reflects the rating on Sharjah as the transaction fulfills the five conditions of our criteria for rating sukuk (see "Related criteria" section):

Under our criteria, we therefore equalize the sukuk rating with our long-term foreign currency sovereign credit rating on Sharjah. The rating on the sukuk transaction is preliminary and

based on draft documentation. Should final documentation differ substantially from the draft version, the rating on the sukuk could be changed. This report does not constitute a recommendation to buy, hold, or sell the certificates. Standard & Poor's neither structures sukuk transactions nor provides opinions with regards to compliance of the proposed transaction with Sharia.

A sukuk with sufficient contractual obligations for full and timely repayment

The transaction involves a special-purpose company incorporated in Cayman Islands, issuing rated sukuk trust certificates. The proceeds of the sukuk will ultimately be used for Sharjah's general funding purposes.

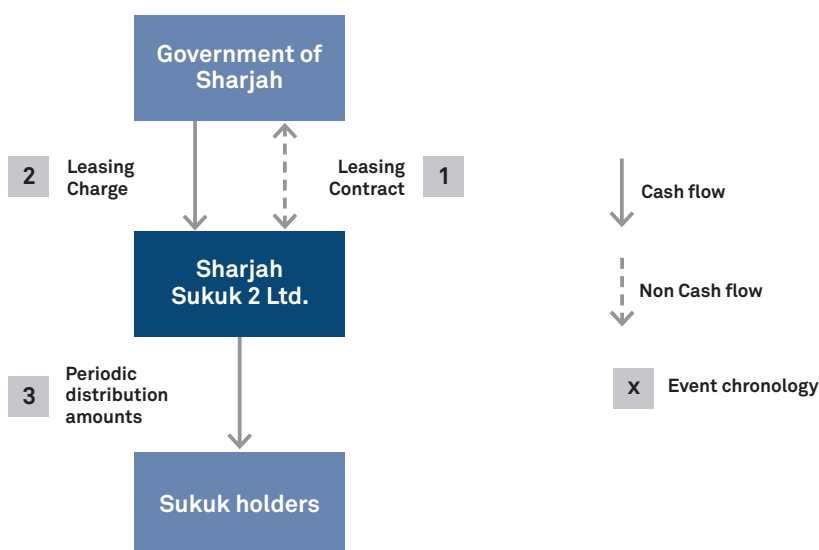
Upon close of the transaction, the issuer will enter, among other contracts, into an Ijara agreement with the government of Sharjah. Under this agreement, the sukuk underlying assets will be leased to the government of Sharjah at a pre-determined rent calibrated to match the periodic distribution amount on the sukuk and any other costs related to the transaction (see chart 1). Sharjah, as lessee, will undertake to pay the leasing charge in a timely manner to allow the issuer to pay the periodic distributions to the sukuk holders. These obligations are unconditional and will rank pari passu with Sharjah's other general obligations.

At the maturity date of the transaction or upon the occurrence of an early dissolution event, Sharjah will buy back the underlying assets at an exercise price sufficient to redeem the sukuk principal together with any accrued and unpaid periodic distribution amount and any other expenses (see chart 2). The obligations of Sharjah under the purchase undertaking are irrevocable, and will rank pari passu with all Sharjah's other general obligations. The costs related to the transaction will be covered through supplementary lease charges payable along with the leasing charge under the leasing contract.

Table 1 - Sharjah Sukuk 2 Ltd. Transactions Details

| | |
|--------------------------------|--|
| Issuer, trustee, and principal | Sharjah Sukuk 2 Ltd., incorporated in Cayman Islands |
| Seller of the assets | Government of Sharjah |
| Servicing agent | Government of Sharjah |
| Periodic principal repayment | Semi annual |
| Global coordinator | HSBC Bank PLC |
| Joint lead managers | Bank of Sharjah, Barclays, Commerzbank, HSBC, Dubai Islamic Bank, Sharjah Islamic Bank |
| Principal paying agent | HSBC Bank PLC |
| Registrar and transfer agent | HSBC Bank PLC |
| Governing law | English law and Sharjah law for the leasing contract |

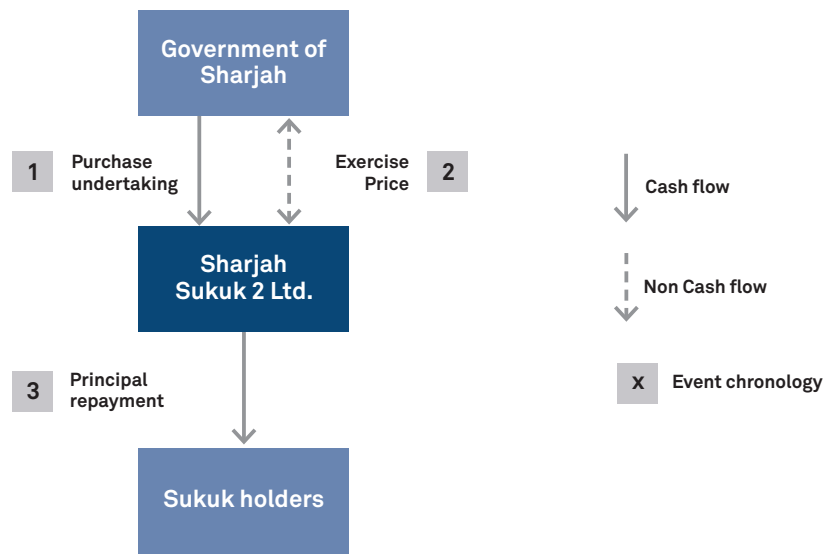
Chart 1 - Sharjah Sukuk 2 Ltd. - Periodic Distributions Payment



Total Loss Event

While a total loss event risk is mentioned in the documentation, we assess as remote the risks that such an event would jeopardize the full and timely repayment of the sukuk. Our opinion is based on the unconditional obligations of Sharjah to make up any shortfall between the insurance proceeds (if any) and the reinstatement value (defined as the outstanding face amount of the sukuk together with the periodic distribution amount payable for a 30-day period) on the 31st day following a total loss event.

Chart 2 - Sharjah Sukuk 2 Ltd. - Principal Repayment



Islamic Finance Could Aid Modestly In Achieving Sustainable Development Goals

In September 2015, the UN General Assembly adopted its 2030 agenda for sustainable development, comprising 17 sustainable development goals (SDGs) and 169 measurable targets centered on five pillars: people, planet, prosperity, peace, and partnership. The UN has stressed that striving for sustainable development will require a revitalized global partnership between all stakeholders.

Islamic finance could play a role--a modest one at least--in meeting some of the SDGs, in Standard & Poor's Ratings Services' opinion, particularly those that are in line with the core principles of Islamic finance. Some sukuk issues by global multilateral lending institutions over the past few years illustrate this point although their overall amount remains small compared with multilateral lending institutions' (MLIs) conventional debt issuance. Still, Islamic finance will likely remain a modest contributor due to the industry's small size and the issues it has yet to resolve to unlock its global potential.

Islamic Finance Principles And Products Are Compatible With Some Sustainable Development Goals

To be considered Sharia-compliant, a financial institution or transaction needs to meet the Koran's tenets against usury and uncertainty. Perhaps the most famous principle of Islamic finance is the prohibition of Riba. Depending on the school of thought, Riba has been defined as interest or excessive interest, leading to slavery. Sharia doesn't consider money as an asset on its own because it is not tangible; therefore, it may not earn a return from the simple fact of time elapsing. Instead, return can be earned on risk taking activities, as long as the burden or reward is shared between the bank and its client. Although the principle of profit and loss sharing has not been fully or always applied properly

in the past, we think that the industry is slowly inching in this direction. Sharia also prohibits uncertainty of payout, gambling, or speculation (Gharar), and encourages responsible behavior. Moreover, Sharia-compliant transactions must be backed by tangible and identifiable assets that anchor the financial sector in the real economy. Lastly, Islamic finance forbids investment in or dealings with those industries banned under Sharia: notably alcohol and brewing, tobacco, weapons and armaments, or pork-based products. The ultimate goal of these principles is to create a sustainable, equitable, and socially responsible financial system.

Looking at the UN SDGs and the principles of Islamic finance, we consider that there are some similarities. For example, the principle requiring underlying assets in each Islamic financial transaction makes Islamic finance a good match for the financing of infrastructure, which is part of SDGs 6, 7, 9, and 11. Another example comes from the parallel between the prohibition of financing certain sectors such, as weapons and armaments, and SDG 16, aiming to promote peaceful and inclusive societies.

Islamic finance also uses some specific products that can be used to finance SDGs. The first two SDGs aim to end poverty in all forms, and halt hunger and achieve food security in the world. Although these two objectives could probably be dealt with through the use of concessional loans from MLIs or bilateral loans from developed countries, Islamic finance has its own forms of concessional lending, specifically:

- Qard Hassan, consisting of a loan granted for welfare purposes or to bridge short-term funding requirements where the borrower is required to repay only the principal.

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- Zakat, which is one of the five pillars of the Islamic religion and is similar to a tax that is levied on wealth that exceeds a certain threshold. Zakat is used for social welfare purposes without any expectations of repayment or remuneration.
- Waqf, consisting of a donation of an asset or cash for religious or charitable purposes with no intention of reclaim.

Lastly, the principle of profit and loss sharing inherent to Islamic finance could, if implemented properly, contribute to achieving SDG 10, related to reducing inequality and easing the negative impact of economic swings. This principle has not been applied properly in the past but, in our view, the industry is slowly inching toward its more stringent application (see "Why Profit And Loss Sharing May Be Gaining Ground In Islamic Finance," published March 1, 2016, on RatingsDirect).

Global Multilateral Lending Institutions May Opt To Increase Their Use Of Islamic Finance Given The Similarities Between Some Principles And The SDGs

Apart from the Islamic Development Bank Group (IDB) and the role it fulfills in financing the infrastructure in its Organization of Islamic Conference (OIC) member countries, we have seen only a few examples of interest in Islamic finance from other global MLIs in the past few years. The International Finance Facility for Immunization (IFFIm), which focuses on raising funds for the immunization and vaccine procurements programs of Gavi, the Vaccine Alliance (SDG-3), was the first among global MLIs to tap the sukuk market twice. In 2014, the IFFIm issued a \$500 million sukuk that was oversubscribed by 1.4x. This was followed by another sukuk for \$200 million that attracted similar interest from investors, with an oversubscription of 1.6x. In the same vein, the International Finance Corporation

Chart 1 - Islamic Finance Core Principles And UN Sustainable Development Goals

Islamic Finance Principles



Spotlight On...

(IFC) also tapped the market through a \$100 million sukuk in 2015 after a first issue in 2009, with underlying assets consisting of private-sector projects in the Middle East and North Africa.

Although the oversubscription rates are somewhat lower for these MLIs' sukuk than for some governments or private sector sukuk issued over the past few years, we consider that access to the sukuk market could offer MLIs the opportunity to diversify their funding bases and tap liquidity that is not allowed to go the conventional route. By our estimates, the overall size of the investor base looking to invest in Sharia compliant instruments such as sukuk at about \$500 billion worldwide. With the IFFIm sukuk, for instance, around 65% of the investors were based in the Middle East and financial institutions made up three-quarters of the total.

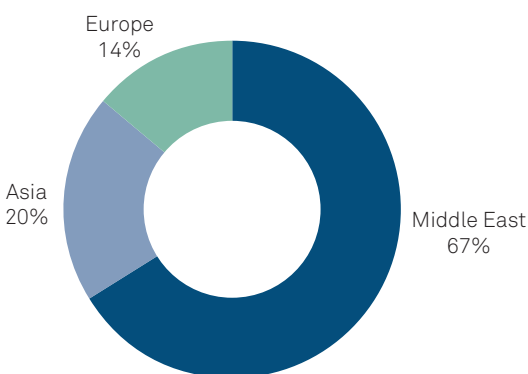
In addition, with Basel III deadlines approaching for some Islamic finance core markets and the chronic lack of high quality liquid assets (HQLA) in the industry, we think sukuk issues by MLIs might attract some interest. Most MLIs have high credit ratings ('AA' and above) and benefit from HQLA eligibility under the Basel

III liquidity coverage ratio. With the significant role global MLIs will have to play in achieving the SDGs and given the compatibility of some of their operations with the principles of Islamic finance, we expect to gradually see more sukuk issuance from global MLIs in the next few years.

Islamic Finance Could Help But Its Contribution Will Be Modest

We think that Islamic finance's contribution to financing some SDGs will likely remain modest. This is mainly because of the industry's small size compared with the overall financial system, even in the economies of OIC member countries. We estimate Islamic finance assets were worth about \$2.1 trillion at year-end 2015, compared with more than \$7 trillion of cumulative GDP of the economies of the OIC countries at the same date. Similarly, we project that sukuk issue volumes will reach \$50 billion-\$55 billion in 2016, representing only a negligible fraction of conventional issues globally. Assuming the industry continues its efforts to improve standardization and reduce the usual timeframe for issuing sukuk, Islamic finance could attract new issuers such as MLIs or governments that might see the industry as a way to diversify their investors' base and fund their SDG agendas.

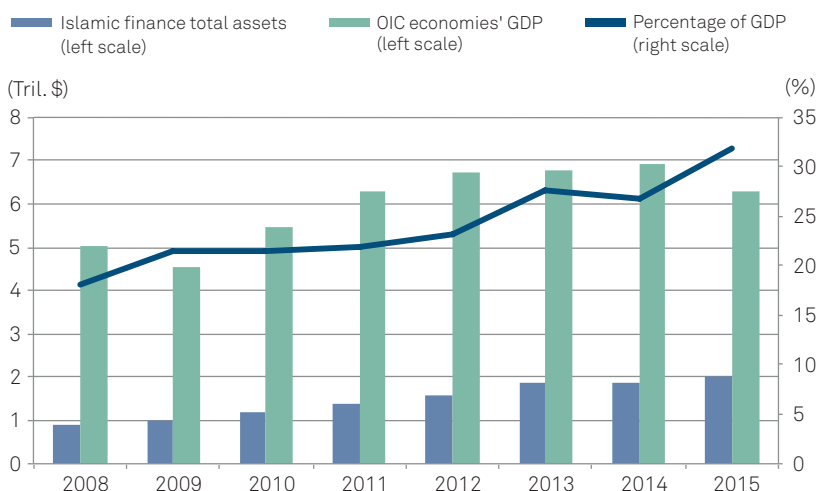
Chart 2 - International Finance Facility for Immunization Sukuk Investor Base



Sources: Zawya and Standard & Poor's

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Chart 3 - Islamic Finance Assets Versus GDP Of Organization of Islamic Conference Economies



OIC - Organization of Islamic Conference Economies.

Sources: International Monetary Fund and Standard & Poor's.

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Why Profit And Loss Sharing May Be Gaining Ground In Islamic Finance

Global financial systems are moving toward liabilities bailing-in through the introduction of resolution regimes and the requirement that some banks set aside a certain amount of loss-absorbing instruments. We believe Islamic finance might be headed in the same direction and thus inching closer to applying one of its five basic principles, profit and loss sharing.

Although profit and loss sharing has not been widely applied by Islamic banks to date for numerous reasons, we believe this will change in the next few years if and when local regulators for Islamic finance core markets--which include the Gulf Cooperation Council (GCC; Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates) countries, Malaysia, and Iran--start implementing resolution regimes.

Profit And Loss Sharing Has Not Been Widely Applied In Islamic Finance

The principle of profit and loss sharing in Islamic finance stipulates that no return should be served without proper risk taking. It implies that an Islamic bank can transfer financing and investment losses to its profit sharing investment account (PSIA) holders, which are viewed as partners in these investments. The Islamic Financial Service Board supports this principle in its capital adequacy standard (IFSB-15) that recognizes banks' capacity to share losses with their PSIA holders at least partially (through the alpha factor that determines to what extent losses can be shared). It is important to mention that the industry currently recognizes two types of PSIAs, restricted and unrestricted.

Restricted PSIAs

Restricted PSIAs are reported off-balance sheet and their holders set the investment strategy to be used by the bank in deploying these funds. These instruments fully absorb losses in case of poor performance of their underlying assets. The bank is remunerated for its asset-management

services and does not take risks related to the underlying assets of these PSIAs.

Unrestricted PSIAs (UPSIAs)

UPSIAs are reported as deposits on the balance sheet of Islamic banks similarly to conventional banks. Theoretically, their holders are supposed to take the risks of the underlying assets of these PSIAs and share the losses in case of poor asset performance.

In order to assess whether the profit and loss sharing principle was applied to UPSIAs, we looked at a sample of the largest Islamic banks in the GCC countries and Malaysia that contribute to about 90% of the total Islamic banking assets (excluding Iran). Our findings show that the banks have not applied this principle over the past three year, given that none served negative returns to UPSIAs holders. In addition, to our knowledge, this principle was never applied in the past. In our view, there are three main reasons for this:

- Firstly, the banks that we looked at were consistently profitable and did not need to resort to their depositors to cover losses. The average return on assets for these banks stood at 1.5% on average for 2012-2014.
- Secondly, applying profit and loss sharing without properly explaining the principle to depositors in advance could result in significant deposit outflows for banks and even jeopardize their financial stability. If depositors were served negative returns, they may withdraw their deposits and switch to conventional banking or other profitable Islamic banks. Such a move could be detrimental to some banks, since UPSIAs constitute one of the most important refinancing sources for Islamic banks.
- Finally, Islamic banks try to offer similar products and returns as their conventional

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competitors to avoid putting themselves at a disadvantage or having to provide higher returns to clients to compensate for additional risks.

Islamic banks have also developed various layers of defense, such as profit equalization reserves (PER) and investment risk reserves (IRR), to protect their depositors from volatile profitability and minimize the risk of resorting to their funds to cover losses. PER and IRR are similar to countercyclical buffers that Islamic banks set aside based on the profitability of good years to cover the performance of less profitable years. Over the past three years, some of the banks in our sample resorted to PER and IRR to smooth the return served to their PSIA's holders.

Global And Local Winds Of Change

Nevertheless, we are of the view that Islamic banks might apply the principle of profit and loss sharing more stringently in the future for two main reasons:

- Advanced financial systems have moved toward allowing loss absorption in a certain category of liabilities through the introduction of resolution regimes and the requirements that some banks set aside a certain amount of loss-absorbing instruments. We think that the regulators in core markets for Islamic finance are likely to follow this trend in the coming years.
- Economic conditions in some core markets for Islamic finance are also becoming less supportive. The economies of some of these markets are heavily dependent on oil, the price of which has plummeted over the past 12 months. We believe that this shift will result in higher credit losses and lower profitability, which in turn could lead at least to lower, or even negative, returns (at least in theory) being served to UPSIAs holders.

New Instruments Allow For Loss Absorption

We have also observed the creation of new Islamic instruments that include provisions for loss absorption over the past five years and, we view them as paving the way for profit and loss

sharing. These are primarily in form of sukuk eligible for capital inclusion under the domestic capital adequacy regulations. Specifically, we have seen two types of instruments:

Tier 1 sukuk

Over the past five years, we have seen issuance of Tier 1 sukuk in the United Arab Emirates, Saudi Arabia, and Qatar. Banks in these countries have raised a total of \$4.9 billion. Under the terms and conditions of some of these sukuk, their sponsors were given the possibility to suspend the payment of periodic distributions in case of poor performance of the sukuk underlying assets. For some of these structures, sponsors were also given the possibility to provide liquidity facilities to cover losses under their obligations and deduct the amount provided from the principal of the sukuk if it is repaid. As such, any losses incurred will usually be transferred to sukuk holders, whether on the spot or on deferred basis (for example, at the time of the sukuk's repayment).

Tier 2 sukuk with a point of non-viability clause

While these instruments do not bear losses on a going-concern basis, some of them can be called upon when the institution breaches the minimum capital adequacy ratio regulation. These instruments were used in Turkey, Malaysia, Saudi Arabia, and Pakistan, and allowed banks in these countries to raise \$6 billion over the past five years.

We believe that such instruments not only allow for application of the profit and loss sharing principle but also open the way for the introduction of loss absorption in other instruments, such as UPSIAs. However, we think that will be done in conjunction with the implementation of resolution regimes in core Islamic finance countries, which could take some time to materialize. We think that if and when that takes place, UPSIAs could be used as "bailinable" instruments due to their embedded profit-and-loss-sharing characteristics, or we could see the emergence of a new class of liabilities for Islamic banks similar to the additional loss-absorbing capital (ALAC) instruments that we have seen in the conventional financial industry.

What Could Be The Rating Impact

Under our methodology, we generally view the presence of a category of liability that can protect senior creditors in case of need as positive from a rating perspective. Our hybrid and ALAC criteria allow us to factor in the presence of these instruments in our ratings.

However, the impact on ratings can also be negative. The implementation of resolution regimes in some advanced countries was aimed at insulating taxpayers from financing future bank failures. Following the implementation of Bank Recovery and Resolution Directive in Europe, we revised our support assessment for most European countries to support uncertain from supportive to reflect our view that extraordinary government support for systemically important banks is now unlikely in these banking systems. This, in turn, has led us to take out notches of extraordinary government support that were incorporated in our ratings on some of these banks (see "Credit FAQ: How

Standard & Poor's applied its government support and ALAC criteria to European banks in December 2015," published Dec. 2, 2015, on RatingsDirect). That said, for some banks, the removal of support was partially or totally offset by the incorporation of ALAC uplift in their final ratings.

Currently, we assess most governments in GCC countries and Malaysia as highly supportive toward their banking systems, and, as such, we do factor notches of extraordinary government support in our ratings on the systemically important banks we rate. If these countries move to implementing resolution regimes and we start doubting their willingness to extend extraordinary government support to systemically important banks, we might revise our assessment of government support and remove notches of uplift. At the same time, we might look at the additional loss-absorption instruments that could be introduced and factor them in our ratings, in line with our ALAC criteria.

Africa's Small Sukuk Market Shows Significant Promise

Overview

- Given Africa's significant funding and infrastructure needs, sovereigns there could benefit from an active sukuk market.
- Yet without clear legal and tax frameworks, few will be in a position to issue sukuk for the next several years.
- In our view, the increasing involvement of multilateral institutions is one of the keys to unlock the full potential of the continent's fledgling sukuk market.

Africa's extensive infrastructure development needs create a fertile environment for the growth of sukuk issuance over the next decade, in S&P Global Ratings' view. Yet so far the market comprises only \$2 billion of sukuk from a handful of issuers. By contrast, 17 sub-Saharan African (SSA) governments we rate issued \$46 billion of conventional debt in 2015 alone. We believe African sukuk can provide diversification benefits for Islamic investors as well as additional financing opportunities. Moreover, we think sovereign sukuk issuance could, in the long term, facilitate the development of Sharia-compliant private-sector sukuk on the continent.

Despite sukuk's widespread appeal to investors, we expect that only a few African countries will tap the sukuk market over the next 12 months, for several reasons. First, we see a general lack of clear legal and tax regimes to support a thriving sukuk market, and in many cases, the complexity of structuring sukuk could deter issuance. However, multilateral institutions could become increasingly important in enabling countries to enter the sukuk market. This was illustrated by Senegal's issuance of sukuk in 2014 and 2016, aided by technical support from the Islamic Corporation for the Development of the Private Sector (ICD). We see South Africa and Côte d'Ivoire as serious contenders to attract foreign investors because of their large infrastructure projects,

which need institutional funding. In addition, these two countries benefit from a well-developed financial infrastructure that could help them become financial hubs for such transactions.

Infrastructure Needs Are High But Fiscal Flexibility Is Generally Low

African governments' capital expenditures will likely increase in the face of sizable long-term development and infrastructure needs. We estimate the average GDP per capita of rated SSA sovereigns will be just \$1,900 at the end of 2016, reflecting low wealth levels across the continent. Many countries in the region are therefore implementing policies to increase their economies' productive capacity to secure long-term sustainable growth and wealth.

This requires significant capital investment in infrastructure projects, ranging from those to ensure consistent power supply, to transportation networks that can facilitate trade. In Kenya, for example, the Standard Gauge Railway project--under construction for an estimated total cost of \$4 billion--aims to deepen regional trade links by providing export facilities for otherwise land-locked producers. In Côte d'Ivoire, the government's almost €45 billion national development plan is intended to support the country's industrialization by 2020. Senegal has also implemented a new development plan to boost growth, which would entail relatively high public-sector capital expenditure. And Nigeria is moving to build capacity in its power sector, while improving transport networks through the Standard Gauge Railway Modernization Project started in 2011.

However, it is uncertain whether sovereigns will have the resources to continue such investments at the same pace, in particular new infrastructure projects. High reliance on hydrocarbons and other commodity exports has continued to take its toll on many major African economies and public finances, owing to depressed prices. We

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therefore expect mounting fiscal pressure from lower revenues will become an obstacle for African governments. What's more, we expect consolidation measures may include cuts to capital expenditures, which could negate what we see as a good fit between infrastructure development and sukuk issuance because of the need for tangible assets as part of sukuk transactions. We estimate the average fiscal deficit of rated SSA sovereigns at 5% of GDP in 2016 and just over 4% in 2017, compared with an average of 4.6% in 2014-2015, implying ongoing funding needs.

Over the past few years, SSA sovereigns have enjoyed unusually favorable financing conditions, with many issuing bonds in the global capital markets for the first time, and yields hit all-time lows in mid-2014. In our view, this was largely the result of exceptionally loose monetary policies that central banks in the developed world have pursued and advantageous commodity prices. But the tide has turned. We expect that the majority of these sovereigns will direct an increasing share of revenues over the next three years to servicing debt. At the same time, we expect that the gradual normalization of interest rates in the U.S. will likely subdue pricing of conventional debt and sukuk. We see some upside for sukuk issuance as a mean of diversifying regional governments' funding away from primary sources such as concessional borrowing and, to a somewhat lesser extent, domestic financing.

Eurobond issuance has gained importance for several SSA sovereigns in recent years, given the attractive foreign financing conditions. It is therefore unsurprising that conventional debt instruments far outweigh sukuk in African debt markets, and we expect this will continue. Within SSA, the larger Eurobond issuers (such as the Kenyan, Nigerian, and Ghanaian governments) typically have fairly developed domestic capital markets and higher GDP per capita, and fewer concessional facilities are available to them.

Legislation And Multilateral Institutions Could Spur Activity

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

We see for instance that the South African government's amendments to legal and tax laws for its first sukuk have enabled the country to solicit the market on an ongoing basis. In West Africa, the regulatory framework for sukuk in Senegal is also applicable to the other seven countries in the West Africa Economic and Monetary Union (WAEMU): Benin, Burkina Faso, Côte d'Ivoire, Guinea Bissau, Mali, Niger, and Togo. After the Senegalese government issued its debut, albeit modest, sukuk of CFA franc (XOF) 100 billion (about \$170 million) in 2014, Côte d'Ivoire followed suit late in 2015 with the first tranche of its XOF300 billion program for 2015-2020. Togo became the third country in the WAEMU zone to make its debut after launching an XOF150 billion sukuk in July 2016, shortly after Senegal issued its second sukuk of XOF150 billion in June. We believe neighboring countries are likely to enter the market more quickly and easily as a result of these transactions.

In a similar vein, the involvement of multilateral institutions (MLIs) could foster increased issuance. We have seen that technical assistance from MLIs, like the Islamic Development Bank and ICD, and from domestic institutions such as central banks, has expedited African sovereign sukuk issues, particularly in WAEMU. The ICD initially partnered with Senegal's central government and other institutions to help establish the necessary framework to issue sukuk in WAEMU. The Senegalese sukuk was the first of a series that will be issued by West African states and supported by the ICD. Such initiatives can benefit the development of a regional Islamic

debt market, as the creation of the Bourse Regionale des Valeurs Mobilières (WAEMU's regional stock exchange) did for the conventional debt market in Côte d'Ivoire. In addition, the Central Bank of West African States has agreed that banks may use sukuk in repurchase transactions to encourage them to invest in sukuk.

Only Lasting Change Can Bring Faster Market Expansion

On balance, we expect that few sovereigns in SSA will venture into sukuk issuance over the next year, despite continually high spending needs. The implementation of a suitable legal framework that will accommodate sukuk issuance could take years, however.

That said, we believe multilateral and domestic institutions will continue to play a crucial role as enablers to market entry. Côte d'Ivoire and Senegal, the two largest economies in WAEMU, have managed to attract domestic and foreign investors for their sukuk to finance infrastructure projects. The successful launch of landmark sukuk in SSA could prompt other sovereigns in the region, notably Nigeria, to enter the market, in our view. Some countries display positive foreign investment flows, strong growth prospects, relatively diverse economies, and fairly well-developed capital market infrastructures by regional standards. These factors bode well for the development of Islamic finance hubs in Africa over the long term.

Weak Operating Environment Will Weigh On Gulf Cooperation Council Islamic Banks' Financial Performance

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S&P Global Ratings believes that the weak economic environment will negatively weigh on the financial performance of Islamic banks in the Gulf Cooperation Council (GCC) countries in 2016 and 2017. The oil price has dropped by more than 70% since mid-2014, creating challenges for growth, and fiscal and external hurdles for the GCC countries. Nevertheless, we think that GCC Islamic banks have built sufficient buffers to navigate through this new environment with manageable deterioration of their financial profiles.

Islamic banks in our sample (see the section, Composition of Our Sample, for additional details) continued to display strong asset quality indicators, profitability, and capitalization in 2015 by global and regional standards. We also think that the current environment is creating an opportunity for the local regulators to start inching closer to more stringent application of Islamic finance's profit and loss sharing principle. We have seen a few attempts in the industry to move in this direction through the issuance of Tier 1 and Tier 2 sukuk with loss absorption at the point of nonviability (generally defined as a breach of the local regulatory capital ratios), in a trend that we expect to continue over the next two years.

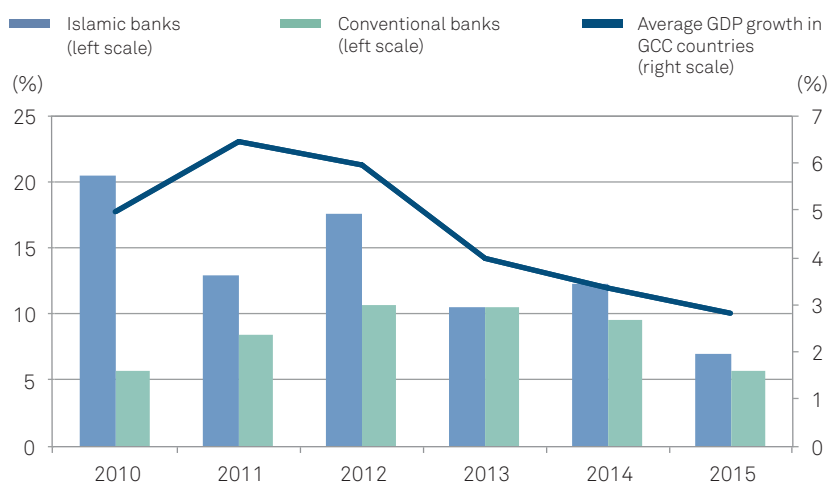
Growth Is Moderating But Disparities Persist

The drop in the oil price that started since the second half of 2014 resulted in a significant slowdown of the GCC economies and reduced growth opportunities for their banking systems. S&P Global Ratings now forecasts oil prices will reach US\$50 per barrel in 2018, with unweighted average economic growth of the six GCC countries of 2.1% in 2016 and 2.5% in 2017. As a result, we expect a more pronounced slowdown of the growth of both conventional and Islamic banks in the GCC. Asset growth started to moderate in 2015, reaching 7.0% for Islamic and 5.7% for conventional banks in 2015, compared

with 12.3% and 9.6%, respectively, in 2014 (see chart 1). In our base-case scenario, we assume that growth will drop to around 5% for both types of banks in 2016 as governments strive to restore their fiscal sustainability through a mix of spending cuts and revenue-boosting initiatives.

The story is not the same for all the GCC countries, however. In our view, the economic slowdown will be more pronounced in Saudi Arabia and the United Arab Emirates (UAE). In Saudi Arabia, we expect that the government will cut spending by close to 15%, attempting to offset a decline in government revenues of a similar magnitude. We think that the Saudi government will still maintain spending on strategic infrastructure projects, however, resulting in some growth opportunities for the financial sector. In the UAE, we see the current trend in the real estate sector resulting in fewer growth opportunities for Islamic banks, although investments related to Dubai Expo should help create some opportunities. Qatar

Chart 1 - Asset Growth Comparison: Islamic Vs. Conventional Banks (2010-2015)



Source: Financial Statements of Gulf Cooperation Council (GCC) Banks. S&P Global Ratings.

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Banks

Table 1 – Balance Sheet Growth In Selected GCC Islamic Bank Markets 2010-2015

| (Mil. US\$) | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|-------------------------------|---------|---------|---------|---------|---------|---------|
| Qatar | 30,921 | 42,839 | 51,807 | 58,103 | 69,428 | 81,214 |
| Annual growth rate (%) | 40.9 | 38.5 | 20.9 | 12.2 | 19.5 | 17.0 |
| Relative weight is sample (%) | 14.1 | 17.2 | 17.6 | 17.9 | 19.0 | 20.8 |
| Kuwait | 57,972 | 63,275 | 68,341 | 73,059 | 79,982 | 77,646 |
| Annual growth rate (%) | 14.7 | 9.1 | 8.0 | 6.9 | 9.5 | (2.9) |
| Relative weight is sample (%) | 26.4 | 25.4 | 23.3 | 22.5 | 21.9 | 19.9 |
| Saudi Arabia | 65,202 | 79,037 | 99,276 | 107,415 | 121,264 | 124,593 |
| Annual growth rate (%) | 12.2 | 21.2 | 25.6 | 8.2 | 12.9 | 2.7 |
| Relative weight is sample (%) | 29.7 | 31.8 | 33.8 | 33.1 | 33.2 | 31.9 |
| United Arab Emirates | 65,502 | 63,611 | 74,160 | 86,214 | 94,232 | 107,413 |
| Annual growth rate (%) | 26.9 | (2.9) | 16.6 | 16.3 | 9.3 | 14.0 |
| Relative weight is sample (%) | 29.8 | 25.6 | 25.3 | 26.5 | 25.8 | 27.5 |
| Total | 219,597 | 248,761 | 293,583 | 324,790 | 364,907 | 390,865 |

Source: Financial Statements of Gulf Cooperation Council (GCC) Banks.

and Kuwait appear to be less affected and we expect spending to remain buoyant in Qatar for the preparation of the World Cup 2020, while the government in Kuwait is planning to boost its investment spending and allocate a significant share of new project financing to Islamic banks.

The growth of Islamic banks in Kuwait was negative in 2015, mainly owing to the depreciation of currencies of Kuwaiti banks' foreign affiliates (see table 1). The capacity of the Kuwaiti government to execute its investment plans will be a factor to watch for in the growth of Islamic banks in 2016 and 2017.

Asset Quality Indicators: It's All About The Cycle

Asset quality indicators of GCC Islamic banks remain comparable with their conventional counterparts. Both Islamic and conventional banks remain well entrenched in their local real economies in the GCC. We think that the cycle of improving asset quality indicators came to an end because of the less supportive operating environment. As for conventional banks, we expect a gradual deterioration of GCC Islamic banks' asset quality indicators in 2016 and 2017 and rising credit losses. While some

market participants argue that Islamic banks will fare much better than their conventional counterparts due to the asset backing principle inherent to Islamic finance, we think that they will be on equal footing, as bankruptcy laws remain underdeveloped and foreclosure of the underlying assets remains generally difficult in the GCC.

Some Islamic banks might be under higher pressure due to relatively higher exposure to real estate (either as direct exposure or as underlying asset to ensure the Sharia compliance of the transaction). Banks such as Kuwait Finance House and Dubai Islamic Bank, which have historically displayed higher concentration in the real estate sector, could experience higher pressure on their asset quality indicators relative to peers. Overall, we think that subcontractors and small and midsize enterprises (SMEs) will bear the brunt of the turning economic cycle and prominently contribute to new nonperforming financing formation in 2016 and 2017.

Our base-case scenario excludes the materialization of concentration risk, which is a fact of life in the GCC. We also see as positive the buffers built by GCC Islamic banks over the past few years when the cycle was more supportive.

Table 2 - Asset Quality Comparison: Islamic And Conventional Banks 2010-2015

| Islamic banks (%) | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|-------------|-------------|-------------|-------------|-------------|-------------|
| Nonperforming advances ratio | 6.1 | 5.3 | 4.7 | 4.1 | 3.4 | 3.3 |
| Nonperforming advances coverage | 111.0 | 129.9 | 100.4 | 98.0 | 107.2 | 120.8 |
| New loan loss provisions/average customer loans (%) | 1.2 | 1.2 | 1.1 | 1.0 | 0.9 | 0.9 |
| New loan loss provisions/operating revenues (%) | 19.3 | 20.4 | 18.1 | 16.6 | 15.5 | 14.6 |
| Conventional banks (%) | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
| Nonperforming advances ratio | 6.1 | 5.6 | 4.7 | 3.8 | 3.2 | 2.9 |
| Nonperforming advances coverage | 90.8 | 97.6 | 106.5 | 126.0 | 154.9 | 158.9 |
| New loan loss provisions/average customer loans (%) | 1.4 | 1.1 | 1.1 | 1.0 | 0.9 | 1.0 |
| New loan loss provisions/operating revenues (%) | 21.7 | 18.8 | 18.2 | 18.0 | 15.2 | 17.1 |

Source: Financial statements of Gulf Cooperation Council (GCC) Banks.

Nonperforming loans (NPLs) to total loans were 3.3% on average for our sample at year-end 2015, with an average coverage ratio of 120.8%. Under our base-case scenario, we think NPLs could increase to 4%-5% over the next two years and credit losses could increase by more than 50% over the same period (see table 2).

Funding Is Weakening But Liquidity Is Still Good

Growth in customer deposits slowed to 9.2% in 2015 compared with 16.9% on average in 2014 for the Islamic banks in our sample. We expect this trend to continue in 2016 and 2017 as governments and their related entities, whose deposits depend on oil prices, contribute between 15% and 40% of the total deposits of GCC banks. This is somewhat counterbalanced by the fact that Islamic banks tend to naturally

attract retail depositors due to their Sharia-compliant nature. In addition, the funding profile of GCC Islamic banks remains strong by international standards, in our view. It is mostly dominated by core customer deposits and the use of wholesale funding sources remains limited. The use of sukuk as a source of funding is limited and we do not think this will change anytime soon. Most of recent sukuk issuance by banks in the GCC were capital-boosting sukuk (primarily in the form of Tier 1 sukuk) as their pricing was attractive. As new financing activity slows down, GCC Islamic banks will have less incentive to tap the sukuk market.

GCC Islamic banks' liquidity also remains strong by international standards, and they tend to keep sizable amounts of cash and money market instruments (around 18.0% of total assets at

Table 3 - GCC Islamic Banks: Key Funding And Liquidity Metrics 2010-2015

| (%) | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|--|-------------|-------------|-------------|-------------|-------------|-------------|
| Growth in customer deposits | 24.4 | 25.8 | 24.2 | 16.8 | 16.9 | 9.2 |
| Cash and MM to total assets | 21.6 | 18.8 | 18.7 | 20.3 | 19.1 | 18.0 |
| Stable funding ratio | 117.1 | 120.4 | 119.0 | 121.9 | 116.6 | 113.9 |
| Customer loans (net)/customer deposits | 92.8 | 90.0 | 88.7 | 86.0 | 87.9 | 91.2 |
| Core deposits/funding base | 82.4 | 83.8 | 85.3 | 86.1 | 86.2 | 84.7 |

GCC--Gulf Cooperation Council. MM--Money market instruments. Source: Company financial statements.

Banks

year-end 2015 [see table 3]) due to the lack of high quality liquid assets. Moreover, most of the GCC governments' issuances (with the exception of Oman and Bahrain) were made in conventional forms. In 2016-2017, we think that some of the GCC governments might start to look seriously at tapping the liquidity buffers of GCC Islamic banks through sukuk issuance. The relatively lengthy and complex process related to sukuk issuance has so far acted as a brake for this trend, bringing sukuk standardization to the forefront of policy makers' and market participants' agendas.

Watch Out For The Deterioration In Profitability

S&P Global Ratings anticipates that GCC Islamic banks' profitability will deteriorate in 2016 and 2017. Several factors will come into play, in our opinion:

- Growth opportunities are becoming scarcer as governments cut their expenses to cope with the new oil price reality. We also think that banks will become selective and prioritize quality and risk profile over quantity and profitability.
- Cost of funding will increase due to lower liquidity, a direct consequence of the fall in oil prices. The increase in conventional interest rates might push some clients to switch from unremunerated deposits to profit-sharing investment accounts (PSIAs), exacerbating the pressure on profitability. Very few banks have set aside significant amounts of "profit equalization reserves" and "investment risk reserves" (these are set aside by Islamic banks during good years and used to smooth returns to PSIA holders in case of need). That said, we think that GCC Islamic banks are on an equal

footing with their conventional counterparts as far as cost of funding is concerned.

- We foresee an increase in credit losses due to the less supportive economic environment. Exposure to subcontractors, SMEs, and some private sector retail will lead the trend.

We therefore expect the revenue growth for the banks to decelerate and we expect the banks to focus on their cost base (optimization of branches, etc.) to mitigate the impact. As for their conventional counterparts, we expect the relatively low cost base of GCC Islamic banks to protect their profitability somewhat in 2016 and 2017 (see table 4).

Strong Capital Buffers Provide Effective Shelter From Shocks

The GCC Islamic banks included in our sample continued to display strong capitalization by international standards, with an unweighted average Tier 1 ratio of 16.1% at year-end 2015. We note, however, that capitalization has dropped over the past five years from an average of 20.1% at year-end 2010, as rapid growth of financing was not matched with additional capital raising or conservative dividend payout ratios (see chart 2).

We have, however, observed a few capital boosting sukuk issuances over the past five years, primarily in the UAE, Qatar, and Saudi Arabia. The common characteristic of these sukuk is that they allow for loss absorption at some point (in case of a nonviability event for Tier 2 sukuk and generally at their issuer discretion for Tier 1 sukuk). We see these sukuk helping the industry to inch closer to one of its cardinal principles, which is the profit and loss sharing principle.

Table 4 - GCC Islamic Banks Return On Assets 2010-2015

| (%) | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|------|------|------|------|------|------|
| Net Islamic margin to average earning assets | 3.1 | 3.2 | 3.2 | 3.2 | 3.2 | 3.1 |
| New loan loss provisions/average customer loans | 1.2 | 1.2 | 1.1 | 1.0 | 0.9 | 0.9 |
| Core earnings to average adjusted assets | 1.4 | 1.3 | 1.5 | 1.6 | 1.5 | 1.6 |
| Noninterest expenses/operating revenues | 50.5 | 48.3 | 44.0 | 42.1 | 42.3 | 41.3 |

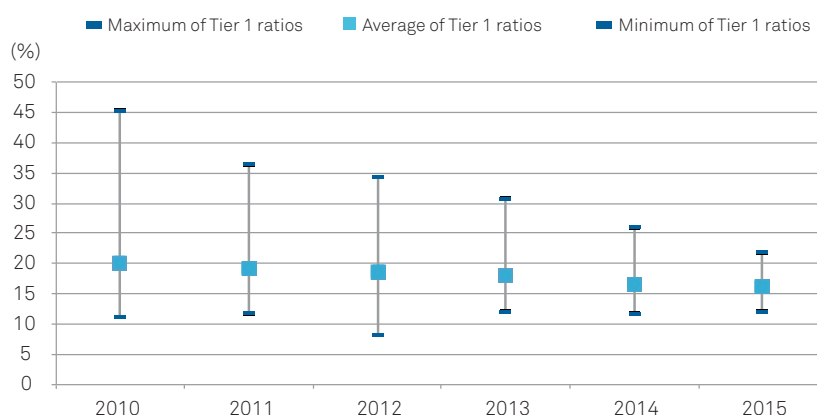
GCC--Gulf Cooperation Council. Source: Company financial statements.

Banks

We think that extension of loss absorption to a certain category of liabilities could strengthen the resilience of GCC Islamic banks. Moreover, as the global financial system is moving toward bailing in a certain category of liabilities and resolution regimes, local regulators could follow suit in the medium term.

We reviewed the characteristics of the Tier 1 sukuk issued by The National Commercial Bank in Saudi Arabia and Qatar Islamic Bank in Qatar and assigned an intermediate equity content to both instruments and incorporate them in our calculation of total adjusted capital. Under the terms and conditions of these two instruments, their respective issuers could defer the periodic distribution payment on a discretionary basis. Moreover; in case of misperformance of the underlying assets of these sukuk, their respective issuers could optionally extend liquidity facility support, provided that this support is repaid whenever and if the instrument is called. Such a feature preserves the loss absorbency nature of these instruments, in our opinion.

Chart 2 - GCC Islamic Banks' Capitalization



GCC--Gulf Cooperation Council.

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Composition Of Our Sample

In order to assess the financial performance of Islamic banks in the GCC, S&P Global Ratings has used a sample of 16 Islamic banks with total assets in excess of US\$5 billion with sufficient financial disclosures. We have not used the

Table 5 - Key Performance Indicators For S&P Global Ratings' Sample Of GCC Islamic Banks, Dec. 31, 2015

| | Country | Islamic bank ranking* | Overall ranking* | Assets (bil. US\$) |
|----------------------------------|----------------------|-----------------------|------------------|--------------------|
| Al Rajhi Bank | Saudi Arabia | 1 | 5 | 84.1 |
| Kuwait Finance House | Kuwait | 2 | 11 | 54.5 |
| Dubai Islamic Bank | United Arab Emirates | 3 | 16 | 40.8 |
| Qatar Islamic Bank (S.A.Q) | Qatar | 4 | 17 | 34.9 |
| Abu Dhabi Islamic Bank PJSC | United Arab Emirates | 5 | 21 | 32.2 |
| Al Baraka Banking Group B.S.C. | Bahrain | 6 | 26 | 24.6 |
| Bank Al-inma | Saudi Arabia | 7 | 28 | 23.6 |
| Masraf Al Rayan | Qatar | 8 | 30 | 22.8 |
| Bank Aljazira | Saudi Arabia | 9 | 33 | 16.9 |
| Emirates Islamic Bank PJSC | United Arab Emirates | 10 | 34 | 14.5 |
| Ahli United Bank B.S.C. | Kuwait | 11 | 37 | 12.9 |
| BARWA BANK P.Q.S.C | Qatar | 12 | 38 | 12.4 |
| Al Hilal Bank PJSC | United Arab Emirates | 13 | 39 | 11.7 |
| Qatar International Islamic Bank | Qatar | 14 | 40 | 11.1 |
| BOUBAYAN BANK K.S.C.P. | Kuwait | 15 | 42 | 10.3 |
| Sharjah Islamic Bank | United Arab Emirates | 16 | 45 | 8.1 |

*Ranking by total assets. GCC--Gulf Cooperation Council. Source: Company financial statements.

Banks

Islamic windows/activities of some conventional banks in our sample, 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). We have

adopted the same approach for the conventional banks that we used in this commentary using banks with balance sheet in excess of US\$5 billion for which we have sufficient financial disclosure. For the list of banks used, please refer to tables 5 and 6.

Table 6 - Key Performance Indicators For S&P Global Ratings' Sample Of GCC Conventional Banks, Dec. 31, 2015

| | Country | Conventional bank ranking* | Overall ranking* | Assets (bil. US\$) |
|---------------------------------|----------------------|----------------------------|------------------|--------------------|
| Qatar National Bank | Qatar | 1 | 1 | 147.9 |
| The National Commercial Bank | Saudi Arabia | 2 | 2 | 119.7 |
| National Bank of Abu Dhabi | United Arab Emirates | 3 | 3 | 110.7 |
| Emirates NBD PJSC | United Arab Emirates | 4 | 4 | 110.7 |
| National Bank of Kuwait S.A.K. | Kuwait | 5 | 6 | 77.8 |
| Samba Financial Group | Saudi Arabia | 6 | 7 | 62.7 |
| Abu Dhabi Commercial Bank | United Arab Emirates | 7 | 8 | 62.2 |
| First Gulf Bank PJSC | United Arab Emirates | 8 | 9 | 61.9 |
| Riyad Bank | Saudi Arabia | 9 | 10 | 59.5 |
| The Saudi British Bank | Saudi Arabia | 10 | 12 | 50.0 |
| Banque Saudi Fransi | Saudi Arabia | 11 | 13 | 49.0 |
| Arab National Bank | Saudi Arabia | 12 | 14 | 45.4 |
| HSBC Bank Middle East Ltd. | United Arab Emirates | 13 | 15 | 41.5 |
| Ahli United Bank B.S.C. | Bahrain | 14 | 18 | 34.0 |
| The Commercial Bank of Qatar | Qatar | 15 | 19 | 33.9 |
| BankMuscat S.A.O.G. | Oman | 16 | 20 | 32.6 |
| Mashreqbank | United Arab Emirates | 17 | 22 | 31.4 |
| Saudi Hollandi Bank | Saudi Arabia | 18 | 23 | 28.8 |
| Arab Banking Corp. B.S.C. | Bahrain | 19 | 24 | 28.2 |
| Union National Bank PJSC | United Arab Emirates | 20 | 25 | 27.7 |
| Gulf International Bank B.S.C. | Bahrain | 21 | 27 | 24.2 |
| Doha Bank Q.S.C. | Qatar | 22 | 29 | 22.9 |
| Burgan Bank | Kuwait | 23 | 31 | 22.5 |
| Gulf Bank | Kuwait | 24 | 32 | 17.9 |
| Al Ahli Bank of Kuwait | Kuwait | 25 | 35 | 14.4 |
| Commercial Bank of Kuwait | Kuwait | 26 | 36 | 13.3 |
| National Bank of Ras Al Khaimah | United Arab Emirates | 27 | 41 | 11.0 |
| Ahli Bank Q.S.C. | Qatar | 28 | 43 | 8.9 |
| National Bank of Fujairah PJSC | United Arab Emirates | 29 | 44 | 8.2 |

*Ranking by total assets. GCC--Gulf Cooperation Council. Source: Company financial statements..

Islamic Finance In Indonesia: Growth Is Slowing, But There Is Significant Medium-Term Potential

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Standard & Poor's Ratings Services believes the deceleration of Islamic finance growth in Indonesia that started in 2015 will continue in 2016. We see three main challenges for the sector this year. The first relates to Indonesia's sluggish economy, which could subdue new business for both Islamic and conventional banks. Second, Indonesia's Islamic finance market is small in absolute terms and relative to the wider financial industry, so it lacks the capacity to benefit fully from the country's large corporate entities and infrastructure projects. Third, the regulatory framework is still developing and there is a scarcity of staff qualified in this area.

Yet we think Indonesia offers local Islamic banks significant medium-term growth opportunities. The country is home to the world's largest Muslim population, and banking penetration remains low. In addition, there are significant shortcomings in transportation and energy infrastructure that could lead to investments of more than \$40 billion-\$50 billion per year for the next few years. However, we think project execution capacity in Indonesia is weaker than in other emerging markets, and private-sector investment remains muted. We believe some of the funding for infrastructure projects could come from domestic Islamic banks, or from bilateral and multilateral Islamic financial solutions or sukuk. In this regard, we view the government's efforts to strengthen the foundation for future growth of Islamic finance as a positive step.

Growth Will Likely Remain Weak ...

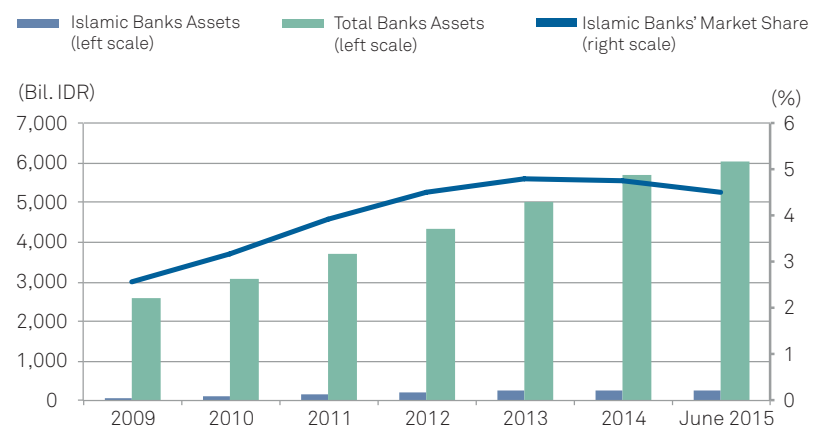
After five years of significant growth, the Islamic finance industry in Indonesia stagnated in 2015. Islamic banking assets increased by about 33.5% on aggregate between 2010 and 2014, but stayed almost flat in the first half of 2015 compared with 5% growth for conventional banking assets (see chart 1). This setback stems primarily from Indonesia's subdued economy, owing to weak

domestic consumption, low private-sector investment, and moderating growth in China. GDP growth in Indonesia averaged 4.7% in the third quarter of 2015 compared with 5.5% on average over the past five years.

We expect this less supportive operating environment to persist in 2016. China represents about 10% of Indonesia's exports, so a faster-than-expected slowdown of activity there can further delay the revival of the Indonesian economy. Exports to China had already fallen by 25.5% in the 12 months to Nov. 30, 2015, according to the Bank of Indonesia. What's more, the Indonesian government has increased public-sector spending to aid long-term growth, but the execution of its ambitious capital program is far behind schedule.

Islamic banks' contribution to the banking system's total assets stood at a meager 4.5% at midyear 2015. That said, due to Islamic banks' lack of scale and higher exposure to retail and

Chart 1 - Islamic Banking Assets In Indonesia



IDR--Indonesian rupiah. Source: Otoritas Jasa Keuangan.

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small and midsize enterprises (SMEs) than the system average, they have suffered more from Indonesia's economic slowdown than their larger, conventional counterparts.

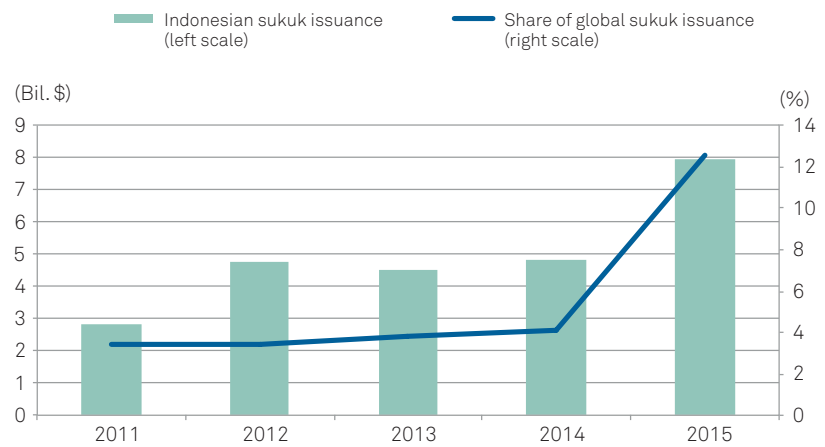
On a positive note, the effect of deceleration in Indonesia has not yet spread to other compartments of the country's Islamic finance industry. The government and a few other entities were quite active in tapping the sukuk market in 2015, with total issuance reaching \$7.9 billion for the year, making the country the second largest sukuk issuer after Malaysia (see chart 2). We believe this reflects Indonesian companies' efforts to diversify their investor bases, as well as the government's push to attract additional sources of financing for infrastructure projects. However, this performance could falter in 2016, since we foresee liquidity tightening in the sukuk market as the U.S. Federal Reserve Bank continues to increase its interest rates and the drop in oil prices affecting investors in major oil exporting countries (see "The Global Sukuk Market: The Correction Is Here To Stay," published Jan. 6, 2016, on RatingsDirect). We think the government's move to front load its sukuk issuance could help it overcome these hurdles.

...But There Are Solid Possibilities For New Business

We believe Indonesia's Islamic finance industry has healthy prospects for future growth. However, we think that unlocking that potential will require aggressive reforms to level the playing field for Islamic banks vis-a-vis their conventional counterparts.

The Indonesian authorities have extended a significant amount of support for the development of Islamic finance through a dedicated roadmap targeting an increase of Islamic banks' market share to 15% by 2023 from 4.5% at midyear 2015. In addition, to ensure swift execution of this strategy, a new committee to identify and implement the necessary reforms was created. The reform agenda includes, among other objectives, enhancing the quality and the quantity of human resources through dedicated training programs and a research center,

Chart 2 - Sukuk Issuance In Indonesia



Sources: Zawya and Standard & Poor's.

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strengthening the capitalization of Islamic banks, and harmonizing regulations and supervision.

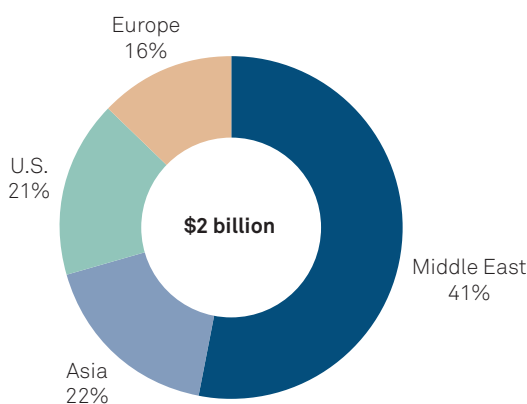
On the retail and SME side, we are of the view that Islamic banks could help the country boost its banking penetration rate, which remains lower than in other parts of the region. According to World Bank estimates, only 36% of Indonesia's population uses banking services as of year-end 2014, compared with 46% on average for South Asia and 81% for Malaysia. This gap is mainly due to the relatively low income levels in Indonesia, with GDP per capita estimated at \$3,410 in 2015, and low financial literacy. Furthermore, it reflects Indonesia's vast land mass and the poor connectivity between its islands. Specific Islamic products, such as Low Income Banking or SME financing, could help boost financial inclusion in Indonesia by offering customers products aligned with their needs and beliefs.

On the investment side, we think that--at this stage--Islamic banking's contribution to financing the country's needs is limited because of the sector's small size. A move toward consolidation could create fewer but stronger banks capable of providing cost-effective infrastructure financing.

Wholesale funding sources, through bilateral/multilateral financing and sukuk issuance could offer another avenue for the country to

obtain infrastructure funding. Indonesia is one of the founding members of the Islamic Investment Infrastructure Bank, which is expected to be established in 2016 jointly with the Islamic Development Bank and other countries. In addition, in 2015, the Indonesian government raised \$2 billion in international sukuk markets through issuance that was not only oversubscribed by 3.4x, but also attracted significant interest from Middle Eastern investors (see chart 3). About 49% of the sukuk proceeds were allocated to assets to be constructed during the life of the sukuk, while the remaining funds were channeled to existing assets to ensure the transaction's compliance with Sharia. We think sukuk issuance could prove to be a win-win situation for the country, since it will help Indonesia attract investors that cannot invest in conventional instruments. For investors, Indonesia provides diversification opportunities in a country whose creditworthiness shows some promise.

Chart 3 - Indonesian Sukuk Issuance In 2015--Investor Distribution



Sources: Zawya and Standard & Poor's

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The Emergence Of New Turkish Banks As Islamic Lenders: A Game Changer?

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Islamic finance in Turkey has grown at a markedly faster pace than conventional finance over the past 10 years. Islamic banks in Turkey, officially known as participation banks, have doubled their share of overall banking assets over the past decade, reaching around 5% at year-end 2015. The annual volume of sukuk issuance increased by around 20x over the same period, to close to \$2 billion by year-end 2015, from \$100 million in 2010.

The Turkish authorities have on several occasions over the past few years announced their intention to support the growth of Islamic finance. We are now seeing tangible steps on that front, such as the launch of the first public sector participation bank in 2015 as well as Vakif Participation Bank as another new Islamic lender. Issuance of sukuk has also grown, denominated both in local and foreign currency, and aimed at attracting foreign liquidity and offering local participation banks with liquidity management and capital-boosting instruments.

S&P Global Ratings believes these initiatives will translate into continued momentum for growth in Turkish Islamic banking. The Gulf Cooperation Council (GCC) region is a good example of visible strategic support for Islamic banking over the past two decades that resulted in sharp growth in Islamic banks' market share. In Qatar for example, the share of lending by Islamic banks increased to around 29% at year-end 2015, from 13% at year-end 2006.

Turkey's Islamic Banks Continue To Grab Market Share

The growth of Islamic banking in Turkey has markedly outstripped that of conventional banking over the past 10 years. The country's participation banks doubled their share in overall banking assets to over 5% by the end of 2015 from 2.5% in 2005.

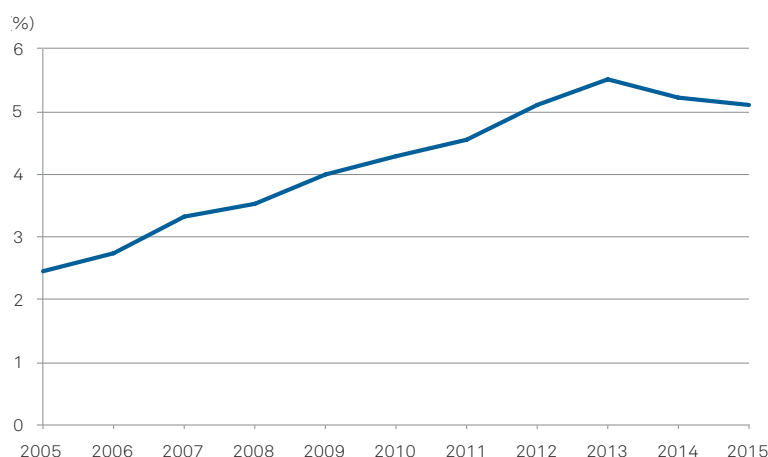
As of year-end 2015, the sector had a total asset size of \$42.2 billion, around 5.6x its size at year-

end 2005. Since the inception of Islamic banking in Turkey in 1985, Islamic banks have largely grown on the back of privately owned capital, particularly through entities that are related to the GCC such as the Islamic banks in Kuwait and Bahrain. Government or public sector banks had no Islamic lending operations until very recently.

After peaking at 5.5% in 2013, the sector's market share seems to have receded slightly to 5.2% in 2014, and 5.1% in 2015 (chart 1). These data have to be interpreted cautiously though, as the decline is largely the result of a significant balance sheet deceleration by Asya Katilim Bankasi A.S. (not rated), which has experienced major difficulties over the past few years. Excluding this impact, the country's Islamic banks have continued to expand their balance sheets at a fast pace.

We expect Turkey's economic growth to average above 3% over our forecast horizon of 2016-2019. However, we still expect a slowdown in credit growth compared with the recent years. Given the additional capital of the two new participation

Chart 1 - Growth In Islamic Banks' Market Share In Turkey



Source: Banking Regulation and Supervision Agency, Turkey.

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banks, we believe the overall growth rates in advances generated by the participation banks as a whole will remain above the growth rate of the Turkish banking sector.

Gulf-Based Institutions Have Fostered The Market

Albaraka Turk Katilim Bankasi AS (BB/Negative/B) started up the Islamic banking market in Turkey, in 1985. Other Islamic banks have come into operation since then, and currently six Islamic banks operate in Turkey, with total assets of \$42.2 billion at year-end 2015 (table 1).

Historically, Gulf-based institutions have been very important in developing Islamic finance in Turkey. As of year-end 2015, the largest Islamic lender in Turkey was Kuveyt Turk Katilim Bankasi A.S., which is majority owned by Kuwait Finance House (KFH; A-/Negative/A-2); the second largest operator is Turkiye Finans Katilim Bankasi A.S., majority owned by National Commercial Bank of Saudi Arabia (BBB+/Stable/A-2); and the third largest Islamic lender is Albaraka Turk Katilim Bankasi AS, which is majority owned by Al Baraka Banking Group B.S.C. (ABG; BB+/Negative/B) in Bahrain. Around 90% of the Islamic assets in Turkey are controlled by these three institutions.

As a country with favorable demographics and long-term growth potential for the banking sector, Turkey has drawn the attention of Gulf-based investors. For two Islamic banks, KFH and ABG, Turkish assets represent a significant portion of their consolidated balance sheets and

this ratio has been growing over the past 10 years. We believe GCC-based institutions will continue to invest in Turkish banking assets. In fact, over the past five years, two of the largest banking acquisition deals in Turkey were by GCC-based investors: The purchase of majority stakes in Tekfen Bank by Burgan Bank (BBB+/Stable/A-2) and the acquisition of Alternatifbank by Commercial Bank of Qatar (BBB+/Negative/A-2). Currently, Qatar National Bank (A+/Stable/A-1) is in the process of finalizing its acquisition of Finansbank.

New Islamic Banks Could Be A Game Changer

In 2015, two participation banks launched their Islamic banking operations. Ziraat Katilim Bankasi AS, the wholly owned subsidiary of state-owned Ziraat Bank (not rated), one of the country's largest lenders, started its operations in 2015. It already had around 33 domestic branches at year-end 2015 according to the Turkey Participation Banks Association. Similarly, Vakif Katilim Bankasi A.S. started providing Islamic banking services in 2015 and we understand it is planning to open multiple branches over the next few years.

We believe the emergence of new Islamic lenders as capital providers in the Turkish Islamic banking market will further contribute to the growth rates of Islamic banking. Total shareholders' equity of the privately owned Islamic banks in Turkey was around \$3.5 billion at year-end 2015 (Bank Asya's financials are dated as of Sept. 30, 2015),

Table 1 - Key Metrics Of Islamic Lenders In Turkey As Of Year-End 2015

| Bank name | Start of operations | Branches in Turkey | Staff | Equity base (bil. \$) | Net advances (bil. \$) | Total assets (bil. \$) | Share of total Islamic assets (%) |
|--------------------------------------|---------------------|--------------------|-------|-----------------------|------------------------|------------------------|-----------------------------------|
| Kuveyt Turk Katilim Bankasi A.S. | 1989 | 356 | 5,445 | 1.2 | 8.9 | 14.4 | 34.2 |
| Albaraka Turk Katilim Bankasi AS | 1985 | 212 | 3,736 | 0.7 | 6.4 | 10.1 | 24.0 |
| Turkiye Finans Katilim Bankasi A.S.* | 1991 | 285 | 4,132 | 1.2 | 9.3 | 13.2 | 31.4 |
| Asya Katilim Bankasi A.S. | 1996 | 199 | 2,986 | 0.4 | 2.2 | 3.2 | 7.9 |
| Ziraat Katilim Bankasi A.S. | 2015 | 33 | 550 | 0.2 | 0.6 | 0.7 | 1.8 |
| Vakif Katilim Bankasi A.S. | 2015 | N.A. | N.A. | 0.3 | 0.0 | 0.3 | 0.7 |

*Known as Anadolu Finans before 2005. Source: Turkey Participation Banks Association and banks' financial reports. N.A.--Not available.

Banks

while the paid-in capital of Ziraat Katilim and Vakif Katilim, the two new Islamic lenders was around \$508 million at the same date, which means a 15% increase in the aggregate capital base of Islamic banks in Turkey. We understand both of these institutions are targeting growth rates that are above the general sector average over the next few years. We believe rather than simply grabbing market share from the existing participation banks, these two institutions will also capture market share and clients from conventional banks as a result of the additional marketing and distribution capacity they generate in the market.

Sukuk Issuance Should Rebound In The Medium Term

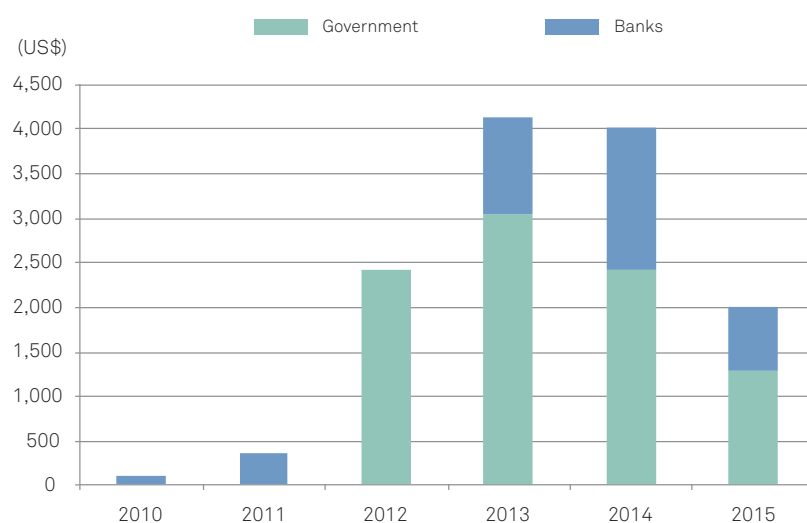
Sukuk issuance has been growing in Turkey and we expect this trend to continue. Total issuance out of Turkey reached a cumulative \$12.9 billion between 2010 and 2015. Kuveyt Turk started the ball rolling in 2010 with \$100 million, followed by two other sukuk in 2011, and then a few government issuances. Turkish participation banks benefited from the appetite of investors to boost their capital adequacy through sukuk issuance amid the depreciating Turkish lira in 2014-2015 (see chart 2). They were also aided by government reforms that introduced a friendlier regulatory framework for sukuk issuance, implemented in 2010 and 2013.

We believe that sukuk issuance could help Turkey to further diversify its investor base and reach investors that are prohibited from dealing with conventional products. For instance, the \$1 billion Turkish sovereign sukuk issued in 2014 attracted \$3.4 billion and was 37% subscribed by investors based in the Middle East.

Nevertheless, total sukuk issuance plummeted in 2015 and this trend continued in the first half of 2016. Low conventional interest rates, certain issues specific to the sukuk market such as the complexity related to structuring versus conventional bonds, and the drop in the growth rate of participation banks explain this trend.

On a positive note, as the participation bank sector continues to develop, we think that

Chart 2 - Sukuk Issuance In Turkey, 2010-2015



Source: Zawya.

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sukuk issuance is likely to increase again in the medium term. We believe that the government will look again at the sukuk market as an alternative way to raise financing while offering liquidity management instruments to participation banks. Participation banks will come back to the market issuing capital-boosting sukuk to raise longer term funds and continue to finance their growth. We do not expect any major activity from corporates, however. A few large corporates have looked at the sukuk market as an alternative financing source, but decided to not pursue for the reasons listed above.

Will Turkey Emulate Qatar's Growth, Thanks To Government Initiatives?

We see Qatar as an interesting comparison with Turkey, as recent government initiatives there have led to significant growth of Islamic banking.

In 2011, the Qatar Central Bank banned conventional banks from extending Islamic banking products through what are called "Islamic windows" in the onshore conventional banking system, thereby requiring conventional banks to close or divest their Sharia-compliant businesses and not underwrite any new Sharia-compliant loans.

Table 2 - The Development Of Islamic Banking In Qatar

| (Bil. US\$) | 2006 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | Period CAGR (%) |
|--------------------|------|------|------|------|------|------|------|-----------------|
| Domestic credit | 26 | 81 | 104 | 131 | 147 | 162 | 183 | 24.1 |
| Islamic banks | 3 | 19 | 24 | 32 | 35 | 44 | 52 | 35.8 |
| % of Islamic banks | 13 | 24 | 23 | 25 | 24 | 26 | 29 | N/A |
| Total assets | 52 | 157 | 192 | 225 | 252 | 278 | 308 | 21.8 |
| Islamic banks | 8 | 33 | 44 | 54 | 60 | 72 | 84 | 29.8 |
| % of Islamic banks | 15 | 21 | 23 | 24 | 24 | 26 | 27 | N/A |
| Resident deposits | 33 | 76 | 94 | 115 | 141 | 152 | 155 | 18.8 |
| Islamic banks | 4 | 18 | 24 | 32 | 38 | 45 | 47 | 30.6 |
| % of Islamic banks | 13 | 23 | 25 | 28 | 27 | 30 | 30 | N/A |

CAGR--Compound average growth rate. N/A--Not applicable. Source: Qatar Central Bank Statistical Bulletin.w

As a result, Shariacompliant banking shifted to the Islamic banks. Furthermore, in 2012, the Qatari government embarked on a treasury bill issuance program to help the country's local conventional and Islamic banks to manage their liquidity. Some of the issuances under this program are structured in the form of sukuk for the country's Islamic banks.

Supported by these government actions, the Islamic banking sector in Qatar has grown more quickly than the banking sector as a whole over the past few years. In 2006, the Qatar Central Bank began to report key balance sheet metrics for each of the Islamic banks. These figures show that the Qatari Islamic banks' market share in domestic credit increased from 13% in 2006 to 29% at the end of 2015.

Although Turkey's overall economic structure and demographics are distinctly different from those of the GCC countries, we expect the Turkish Islamic banks' market share to double to

more than 10% by year-end 2025. In particular, we expect the additional capital that will be deployed by new participation banks to provide important stimulus for the sector.

Nevertheless, although we expect economic growth in Turkey to average above 3% per year over our forecast horizon of 2016-2019, we also expect to see a distinct slowdown in credit growth after years of fast-paced growth. This means that, although we expect Islamic banks to continue to capture overall market share in Turkey's banking system, we still expect average growth rates for the Turkish banking system to decelerate to around 11% between 2016 and 2019. Regulations aimed at curbing rapid growth in retail lending and stricter regulatory capital requirements--Turkey is now officially a Basel III compliant country--will also act as impediments. Nevertheless, we expect the participation banking system's credit growth to remain well above the rates displayed by conventional peers.

Short Track Records, Small Size, And Focus On Retail Lines Count Against The GCC's Islamic Insurers

Islamic insurers in the Gulf Corporate Council (GCC) region saw gross contributions (gross premiums) increase by an impressive 20% or so year-on-year in 2014 and 2015. S&P Global Ratings considers that earnings in the GCC Islamic insurance industry (takaful and Islamic cooperative tawuni) remain relatively weak and are unevenly distributed. For a number of companies operating in these overcrowded markets, we find that precipitous growth, combined with net losses, is eroding their capital strength and damaging their credit profiles.

Most takaful players are still relatively small compared with their conventional peers. Their shorter track records and less-diverse books of business put them at a disadvantage now that the falling oil price and stricter regulation are hitting GCC insurance markets.

In 2015, the combined gross premium income of Islamic insurers in the region exceeded US\$10 billion (based on available data from listed companies), which compares to roughly US\$9 billion of premium income generated by conventional insurers for the year in the GCC. More than 85% of the region's Islamic insurance premiums were written in Saudi Arabia, which has the largest Sharia-compliant market in the region. There are half a dozen explicitly takaful insurers and 28 Islamic cooperative companies operating in Saudi Arabia.

Growth In A Slowing Market

The Islamic insurance industry saw significant premium growth over the past two years as organizations such as the Dubai Health Authority in the United Arab Emirates (UAE) have introduced comprehensive medical insurance schemes and the population has continued to grow. In addition, some markets, particularly Saudi Arabia, have seen strong tariff increases as a result of the introduction of actuarial pricing

guidelines. However, now that more policies are adequately priced, premium growth has slowed. In the first half of 2016, year-on-year premium growth for GCC Islamic insurers slowed to only about 4%.

We consider that the slowdown was chiefly influenced by:

- Increasing selectiveness by some insurers, which are choosing the business they write more carefully to mitigate their risk of underwriting losses;
- Material tariff increases in Saudi Arabia over the past two years, following the introduction of actuarial pricing guidelines; and
- A slowdown in insurable activities as the sharp drop in hydrocarbon prices from the record levels in 2014 hit economic growth across all Gulf countries.

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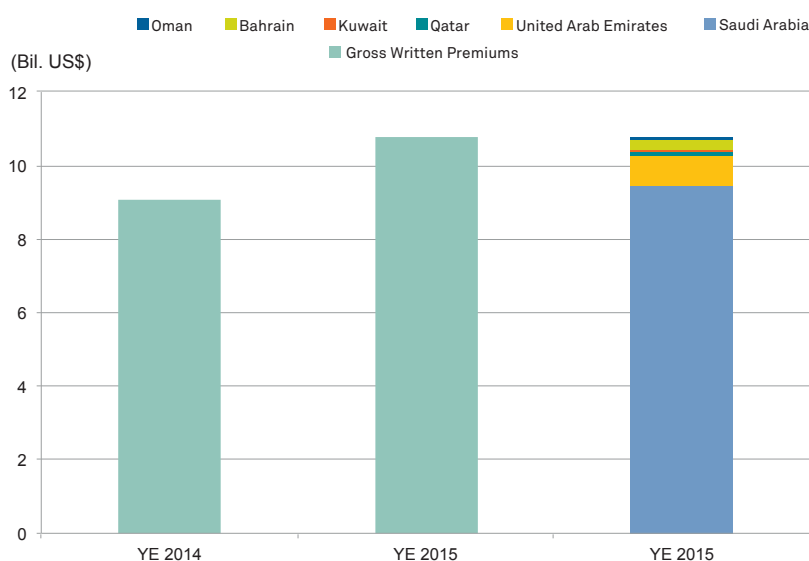
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Chart 1 - Gross Premium/Contribution Growth And Split By Country



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There are still a number of fast-growing companies in the market, but measuring growth in percentage terms can be deceptive. Many takaful companies are still expanding from a relatively small base. For example, eight of the 10 fastest-growing insurers in the first six months of 2016 had a gross premium income of less than \$100 million.

Only A Small Number Of Islamic Insurers Are Booking Strong Profits

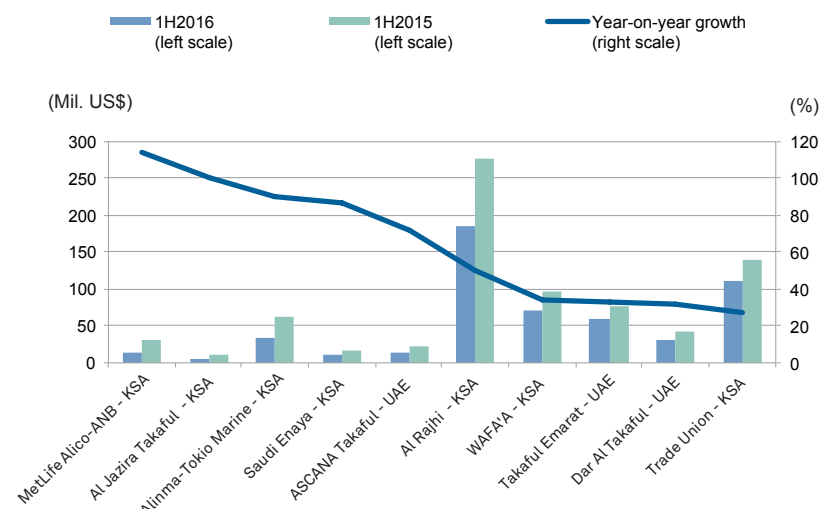
In Saudi Arabia, by far the most-profitable market, all insurers operate on Islamic principles. Including Saudi Arabia, the GCC's Islamic insurance market generated an estimated pretax surplus of more than US\$260 million in 2015 (2014: US\$244 million) and US\$160 million at half-year 2016. But the takaful sector in the remaining GCC states generated a combined net loss of about US\$5 million in 2015 (compared to a net profit of US\$49 million in 2014) and net losses surged to about \$11 million during the first six months in 2016.

Most of the losses stem from weak performance by a small number of players, particularly in the UAE (the second-largest Islamic insurance market). Outside Saudi Arabia, Islamic insurers in the GCC region generally focus on mass-market products, such as medical and motor insurance, where margins are lower. Thus, of the eight takaful companies listed in the UAE, half reported a net profit at year-end 2015, but some of the remaining four were hit so badly, in particular from motor insurance losses, that the overall takaful market in the UAE recorded a total loss of US\$43 million. Half-year results for 2016 indicate that three of the eight insurers are still trading at a loss. We expect that 2016 will be another loss-making year for the overall takaful market in the UAE.

Overcrowding Exacerbates Imbalances, Even In Profitable Markets

Tawuniya/The Company for Cooperative Insurance and Bupa Arabia for Cooperative Insurance Co., the top two companies in Saudi Arabia, generated about 40% of the total market premiums in 2015. Their combined pre-tax profit

Chart 2 - Fastest Growing Companies By Country As at June 30, 2016

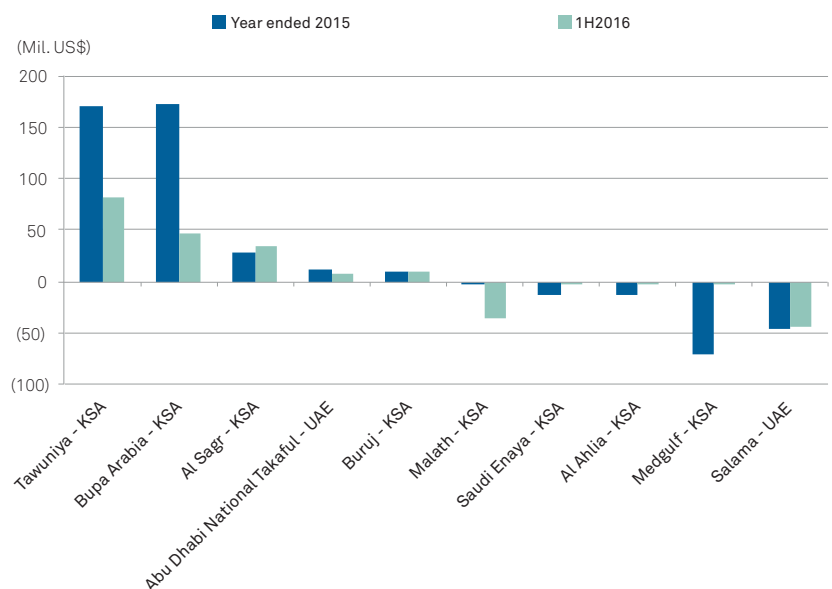


KSA--Saudi Arabia. UAE--United Arab Emirates

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of US\$343 million for 2015 represents 123% of the profit in the market, indicating that the rest of the market suffered an aggregate loss of US\$64 million. Half-year 2016 results suggest a better distribution of profits, but Tawuniya and Bupa Arabia still generated about 41% of total premiums and still had a disproportionate share of total profits at US\$127 million (57%).

Chart 3 - Net Income: Best Versus Worst Performing Companies



KSA--Saudi Arabia. UAE--United Arab Emirates.

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Overall, earnings in Saudi Arabia are improving, but there are still some strong imbalances in the market. In addition to the significant competition in the Saudi Arabian market, insurers are liable to pay the zakat religious tax. At 2.5% of assets, this tax weighs on earnings across the sector.

Elsewhere, we expect Qatar's takaful sector to remain profitable in 2016, even though the first-half results indicate that net profits for the full year are likely to be materially lower than in previous years. Net earnings in the Kuwaiti takaful sector are likely to improve in 2016, as companies are slowly adjusting their motor business following a number of loss-making years.

Takaful Has Yet To Break Into The Most Profitable Business Lines

In our view, the takaful sector is underperforming, especially in UAE, because it lacks the advantages of conventional insurers, which are often larger and benefit from better economies of scale. They have more-established distribution mechanisms and so their revenue generation is less dependent on intermediaries.

In the UAE, most of the listed takaful players are relatively small. The larger, highly rated conventional companies write most of the commercial business; takaful players are often stuck in the highly competitive commodity lines. As a result, although eight out of 29 (28%) of the listed companies in the UAE are takaful players, they write only about 15% of the total gross premiums in the market.

The overpopulated UAE and other GCC insurance markets often suffer from overcapacity, which can often trigger aggressive price wars. In our opinion, Islamic insurance companies require considerable capital investment to become established, yet relatively new companies often come under pressure to generate profits and deliver healthy returns to their investors.

Takaful Insurers Need Scale And A Better Selling Point

Too many takaful insurers in the Gulf lack the scale to operate in overcrowded and highly competitive segments of the market. It seems to us that only those that have the capital strength and time to build scale and develop an effective competitive advantage--for example, by focusing on the still underdeveloped, but often-profitable life (family) business--will prosper.

Can GCC Corporate And Infrastructure Sukuk Issuance Recover From Its Current Stall?

Essential infrastructure funding requirements, low interest rates, and investors' appetite for Islamic assets in their portfolios continue to be supportive for the world's core corporate sukuk markets--the Gulf Cooperation Council (GCC; Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates) and Malaysia. But corporate and infrastructure sukuk issuance has continued to stagnate so far this year and this may carry over to the coming quarters.

Further out, S&P Global Ratings sees possible brighter prospects for issuing corporate and infrastructure sukuk over the medium to long term. We estimate that Gulf government spending on projects alone--including infrastructure contracts awarded over 2016-2019--could be about \$330 billion. We note that with some sovereigns, such as Saudi Arabia, the 2016 budget includes a capital spending allocation of about 9% for what the government defines as "transport and infrastructure." This compares with our estimates of about \$604 billion in projects (including \$100 billion of infrastructure projects) that will need funding through 2019.

We attribute much of the slowdown in corporate and infrastructure sukuk to the current low oil prices, which have affected macroeconomic fundamentals in the GCC. A number of large infrastructure projects in the GCC have either been cancelled or deferred as part of governments' attempts to control expenditures and address fiscal challenges. Fewer projects have broadly meant less funding needs, including in the capital markets. Weakening bank liquidity and low interest rates might otherwise have encouraged greater reliance on capital markets, including sukuk issuance. Meanwhile, we believe that the ease of availability and better pricing of bank loans to corporates continues to curb demand for sukuk issuance.

In the GCC, corporate and sukuk issuance totaled \$2.5 billion in the first eight months of 2016, compared with \$2.3 billion for the preceding eight months), by our estimates. Versus the same periods in 2013 and 2014, issues are down sharply from \$5 and \$6.5 billion, respectively.

Global corporate and infrastructure sukuk issuance was also sluggish over the same period, standing at \$10.8 billion compared with \$13.6 billion in the first eight months of 2015. Although also showing year-on-year stagnation, Malaysia continues to lead the pack, having issued \$4.5 billion so far this year.

Because of the low oil price environment, Gulf sovereigns' most immediate focus has been on how to plug their own fiscal deficits. In our view, this could have constrained corporate and infrastructure sukuk issues by both government-related entities (GREs) and private corporations and projects.

Provided standardization takes place, we see several supportive features that could also contribute to a spurt in issuance over the medium to longer term:

- Governments' and GREs' needs to diversify funding sources to limit concentration exposure to GCC banks;
- Their need for long-term funding to match long-term cash flows from essential infrastructure projects that cannot be deferred or cancelled;
- Deteriorating liquidity at GCC banks;
- Rising interbank rates; and
- Refinancing needs.

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What's Behind The Stagnation?

Several factors explain the current lag in GCC and Asian corporate and infrastructure sukuk issuance: the still-small number of issuers, the predominance of conventional issues, banks' generally high liquidity and low interest rates, alongside the low oil price.

Only a few corporate and infrastructure entities currently issue sukuk in the GCC and Asia

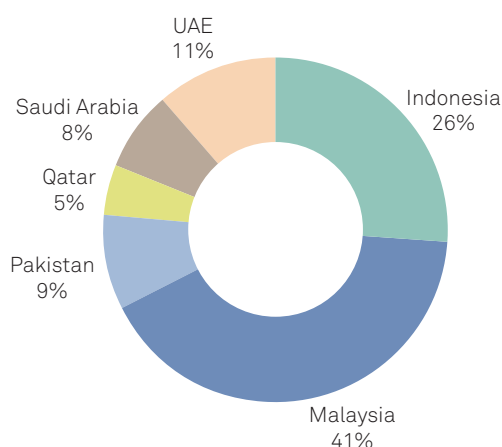
With such a small pool of main issuers, even if just a handful have no compelling need to tap the capital markets in a given year or have recently refinanced or redeemed debt, the resulting drop in issuance can have a big impact on overall volumes. For example, the Dubai Electricity and Water Authority (DEWA) was a major corporate and infrastructure sukuk issuer in the GCC in before 2014 but has had no need to issue new capital market debt in 2015 or so far this year. The highest issue volumes remain in Malaysia (see chart 1).

Conventional financing continues to attract most issuers

A look at issue volumes year to date and in 2015 shows that global issuers are turning more to conventional issuance than sukuk. For example, by our estimates, total GCC sukuk issuance (including corporate and infrastructure, financial institutions, and sovereigns) was about \$9 billion for the first eight months of 2016 (compared with \$12.7 billion over the same period the previous year), paling alongside bond issues of \$41.2 billion over the same period. Bond issues nearly doubled the \$23 billion issued in 2015, with corporate and infrastructure issuance making up about \$5 billion of the total. The spike in GCC sovereign bond issues to \$34.5 billion from \$13.4 billion is the main growth engine, reflecting their mounting needs to stymie fiscal deficits through borrowing. We think the GCC governments continue to prefer the more established conventional bond markets over sukuk.

The difficulty of issuing sukuk--when considering the time and cost spent by sponsors to employ lawyers and drafters of

Chart 1 - Corporate And Infrastructure Sukuk Issuance By Country



NOTE: Data through August 2016. Sources: Zawya and S&P Global Ratings.

© Standard & Poor's 2016

documentation and the need to identify assets linked to the transaction to be sharia compliant--compared with bonds may also be influencing sponsors' decisions to choose conventional bond issuance over sukuk. We would view this as a call for greater standardization in sukuk issuance. So far, we have witnessed generally mild growth in project finance (or asset backed) capital markets in the GCC. This can be interpreted as sponsors shying away from the complexity associated with structuring limited and nonrecourse financings, among other reasons. Adding a sharia element may magnify the existing complexity of structuring asset-backed transactions, which would explain the current muted growth in this type of sukuk financing, and sponsors' preference to structure more plain vanilla sukuk financings.

Despite their liquidity tightening, GCC banks have not fully repriced corporate loans

Low-priced bank debt also continues to be an attractive option for issuers in the GCC and Malaysia. According to various market sources, mainly based on Dealogic data, loans as a proportion of total GCC corporate and infrastructure funding (including loans and bond issues) had increased to represent about 90% of total funding for the first eight months of 2016 from about 74% in 2013.

In the past few years before the current oil price decline, GCC banks had received sizable corporate deposit inflows, in line with strong oil prices. Given the very limited returns on shorter term assets and in the absence of alternative longer term assets, the competition between banks in the corporate loan market has increased substantially, driving down prices. Consequently, the Gulf region's corporates have enjoyed very good access to long-term funding at very affordable rates. As overall liquidity tightens in the GCC banking system, we think this trend is set to reverse. Still, repricing of corporate loans has so far been limited due to the stiff competition in the sector, fueled in part by international lenders who are becoming more active in GCC loan deals.

Low oil prices have spurred sovereign bond issues

The oil price decline has fueled a plethora of debt issues by GCC sovereigns. So far in 2016, Saudi Arabia issued \$10 billion via a syndicated loan from international lenders, with Abu Dhabi issuing \$5 billion and Qatar \$9 billion in the capital markets, and we anticipate more issuance in this quarter and next. In our view, these large issues may have constrained issuance by both GREs and private corporations and projects (for example, GCC corporate and infrastructure bond issuance dropped to \$5 billion year-to-date from \$6.3 billion in the same period in 2015). These issuers have also faced less pressing refinancing needs after deleveraging in 2011-2014, when commodity prices were higher.

In addition, a number of large infrastructure projects in the GCC have either been cancelled or deferred amid governments' attempts to control expenditures and address fiscal challenges. Fewer projects have broadly eased funding needs, including in the capital markets.

Sukuk Are Attracting Some New Corporate And Infrastructure Issuers, As Wakala Structures Gain Ground

Some new issuers have tapped the sukuk market recently, including Qatari real estate

company Ezdan Holding Group, Dubai-based Damac Real Estate Development and the Malaysia-based energy company Petronas in 2015. They join more established sukuk issuers, including utilities DEWA and Saudi Electric Co. and real estate firms Aldar Properties and Emaar Properties.

Wakala sukuk structures with two legs, comprising both Murabaha and Ijara assets as part of the portfolio, for example, are gaining in popularity over traditional sukuk structures that include purely Ijara, Murabaha, or Mudaraba assets. The two-legged structures allow for a relaxation in the minimum level of tangible assets required to achieve sharia compliance, consequently providing corporate sukuk issuers with extra flexibility. The Murabaha is usually the non-tangible leg. This is because of the popularity of commodity Murabaha transactions, which usually involve deferred payment arrangements associated with commodities (as opposed to physical assets such as land and buildings). In addition, in certain jurisdictions--namely Malaysia and Singapore--we are seeing an increase in the use of "rights to services" as part of the asset structure in wakala structures. The rights to services often manifests itself in the form of a grant and sub-grant arrangement between the asset owning company and the issuing vehicle but does not involve a physical transfer of assets to the issuing vehicle. The use of rights to services contracts also reduces the need to isolate and pledge physical assets as part of a sukuk. Rights to services were used in the sukuk issued by the Malaysian government in June 2016.

To date, our corporate and infrastructure sukuk ratings exclusively comprise sukuk that are backed by the irrevocable, unconditional, and timely undertakings of the sponsor. We consequently equalize our ratings on the sukuk with those on the sponsor. Although we acknowledge some residual risk at the level of the issuing vehicle for corporate sukuk, as a result of the potential for de-linkage of the issuer's credit quality with that of the issuing vehicle in extreme scenarios of total loss, such scenarios remain remote.

The Corporate and Infrastructure Sukuk Market Could Deepen Over Time

Provided standardization takes place, we see several supportive features that could also contribute to a spurt in issuance over the medium to longer term:

- Governments' and GREs' needs to diversify funding sources to limit concentration exposure to GCC banks;
- Their need for long-term funding to match long-term cash flows from essential infrastructure projects that cannot be deferred or cancelled;
- Deteriorating liquidity at GCC banks;
- Rising interbank rates; and
- Refinancing needs.

We estimate that Gulf government spending on projects alone--including infrastructure contracts awarded over 2016-2019--could be about \$330 billion. We note that with some sovereigns, such as Saudi Arabia, the 2016 budget includes a capital spending allocation of about 9% for what the government defines as "transport and infrastructure." Taking this and other research into account, we estimate that about \$50 billion out of the \$330 billion that we think will be spent on projects will be allocated specifically for infrastructure (including transport-related projects). This compares with our estimates of about \$604 billion in projects (including \$100 billion of infrastructure projects) that will need funding through 2019.

Among Saudi Arabia's key projects in pre-execution are the \$15 billion Al Mozaini Riyadh East Sub Center, a mixed-use commercial, retail, and residential high-density development in the city of Riyadh. In the city of Mecca, an \$8 billion project for metro lines B and C is to be awarded to help transport pilgrims around the city.

In the UAE, the largest project--also the region's biggest--is Dubai World Central, the extension of Al Maktoum International Airport, currently budgeted at \$32 billion. Another huge project in the UAE is the Al Gharbia Chemicals Industrial City in Abu Dhabi, planned at \$20 billion. The Emirate of Dubai is also pressing ahead with key projects ahead of Expo 2020 Dubai, the next World Expo.

Qatar's largest projects are in pre-execution phase and include QRail, a rail connection between Qatar and neighboring countries ahead of the 2022 FIFA World Cup. Kuwait's main projects in pre-execution are refinery projects--all related to Kuwait National Petroleum Co.

We expect some pressure on governments to defer and cancel discretionary projects to control expenditures in the current GCC economic climate. This will reduce the pool of projects and infrastructure requiring funding. However, we think that out of the remaining pool of eligible project and infrastructure corporate financings, sukuk as a form of financing (in tandem with conventional project and infrastructure) present a viable funding tool.

Sukuk, being an asset linked form of funding, lends itself naturally as a funding tool for financing essential infrastructure. With governments placing a greater onus on sharing the burden of infrastructure spending with the private sector through, for example, the introduction of greater flexibility around public private partnership (PPP) laws in Dubai, Oman, and Qatar, sukuk can provide a form of funding that is suited to PPP-based projects.

We understand that infrastructure sponsors may be considering a number of asset-backed sukuk structures, including green project sukuk as a means for funding energy-related assets. For instance, Saudi Arabia-based issuers Sadara Chemical Company issued a \$2 billion equivalent asset-backed sukuk in 2013 and downstream energy company Satorp issued a \$1 billion asset-backed sukuk

in 2011. These sukuk would be, in our opinion, well suited to funding long-term infrastructure and could lead to important innovation in the market.

We expect corporate entities' refinancing needs will remain significant, with \$23.6 billion in terms of capital market financings coming due (\$11.9 billion of corporate sukuk and \$11.75 billion of corporate bonds) between 2017 and 2019.

Corporate and infrastructure sukuk issuance is likely to remain volatile and difficult to predict in the short term, mainly hinging on the specific needs of existing sukuk issuers in the GCC and Malaysia. We also think that absent important government strategies to promote sukuk, corporate and infrastructure issuers will remain relatively comfortable switching back and forth between sukuk and conventional issuance depending on prevailing conditions, especially pricing and maturity terms. Continued high bank liquidity and uncertainty among investors about compliance standards related to sukuk will continue to hold back growth of the corporate and infrastructure sukuk market, in our view, as will the oil price and economic conditions.

S&P Global Ratings revised its oil price forecasts in early 2016. We now expect the low oil prices

to persist and believe that oil prices will increase only moderately for at least the next two years, averaging \$45 per barrel in 2017 and \$50 in 2018. Given the dependence of core Islamic finance markets on oil, we consequently anticipate that economic growth in some of these markets will remain muted. Under these conditions, Malaysia appears to us as an outlier, since we expect its GDP growth will stabilize at about 4.7% on average in 2017-2018.

Over the longer run, we think the UAE central bank's tightening of lending caps in November 2013, while allowing for exemptions in certain rated bonds and sukuk, will underpin sukuk issuance there over the medium term (for further details, see "The UAE's Lending Caps Affect Domestic Banks, Government Entities, And The Capital Markets," published Jan. 13, 2014, on RatingsDirect). Among the other factors that could spur an improvement in corporate and infrastructure sukuk issuance are companies' growing capital market refinancing needs (particularly in the GCC) over the next few years and their efforts to establish themselves increasingly as sukuk issuers. Moreover, the creation of local or regional institutional investment frameworks--for example, to enable pension or insurance funds to invest in sukuk--would go some way, we believe, toward creating a deeper and more liquid sukuk market.

Islamic Development Bank 'AAA/A-1+' Ratings Affirmed; Outlook Remains Stable

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Overview

- The Islamic Development Bank's core credit metrics have remained relatively stable over 2015 (1436H).
- The bank's risk-adjusted capital after MLI-specific adjustments declined only slightly --to 28% from 30%--reflecting the continued growth of loans to sovereigns with ratings that have deteriorated.
- We therefore affirmed our 'AAA/A-1+' counterparty credit ratings on the bank.
- The stable outlook reflects our expectation that the bank will be able to achieve its mandate without markedly damaging its extremely strong balance sheet.

Rating Action

On Aug. 25, 2016, S&P Global Ratings affirmed its 'AAA' long-term and 'A-1+' shortterm counterparty credit ratings on Saudi Arabia-based multilateral lending institution Islamic Development Bank (IsDB). The outlook remains stable.

Rationale

We base the ratings on IsDB's very strong business profile and extremely strong financial profile, as defined in our criteria for MLIs. We assess IsDB's stand-alone credit profile (SACP) at 'aaa'.

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

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

Since our last full review of IsDB in August 2015, the bank's main operational characteristics have remained relatively stable. Loan growth in 1436 Hijri (1436H, or 2015 under the Gregorian calendar, by our translation) slowed slightly, and capitalization declined marginally but not enough to alter our favorable assessments of the bank's capitalization and liquidity. IsDB's role in developing Islamic finance markets has expanded through the issue of benchmark sukuk and numerous private placements. This points to a sound funding profile, albeit with increasing structural reliance on the sukuk market. The increased ceiling on the bank's medium-term note program--to \$25 billion from \$10 billion--should help the bank maintain its strong liquidity and promote loan growth, thereby supporting the bank's mandate.

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

From a capital perspective, we re-stated our 2014 before- and after-adjustment RAC ratios following a revision to our data. This moved the before-adjustments RAC to 24% from 25% and the after-adjustments RAC to 30% from 32%.

For 1436 (2015), the RAC ratio before adjustments remained steady at 24%; after

Sovereign and Multilateral Lending Institutions

adjustments, it decreased to 28% from 30%. The main reason for the declines is the 15% increase in the bank's sovereign loan portfolio (78% of the total portfolio).

In addition, the bank is exposed to the creditworthiness of Middle Eastern sovereigns. Turkey, the bank's largest exposure, accounts for 8.8% of IsDB's portfolio; Bahrain, 4.1%; Saudi Arabia, 3.7%; and Azerbaijan, 3.5%. We've downgraded several of these sovereigns in recent years for reasons including the fall in oil prices. On July 20, 2016, we lowered our foreign-currency sovereign credit rating on Turkey to 'BB' from 'BB+'. In addition, we downgraded Azerbaijan to 'BB+' from 'BBB-' in January 2016. Consequently, in our adjusted RAC calculation, the adjustment charge for single-name exposures has also increased.

The bank has not distributed dividends to members. Under its articles of agreement, general reserves must amount to 25% of subscribed capital to do so. They were 4.8% as of year-end 1436H (2015) compared to 4.7% the year before. However, all of IsDB's voting shareholders are also borrowing members and, as such, can influence decisionmaking. To fulfill its development mandate while maintaining tight risk-control practices, the bank has continued to expand its presence by recently opening gateway offices in Turkey, Indonesia, and Nigeria.

IsDB's capital comes from the contributions paid by member countries as well as its retained earnings. In 1434H (2013), its board of governors approved the bank's fifth general capital increase (GCI). This elevated the bank's authorized capital to special drawing rights (SDR)100 billion from SDR30 billion and its subscribed capital to SDR50 billion from SDR18 billion. The board also approved to pay in a SDR3.6 billion (US\$5.5 billion), a portion of the fourth GCI, to be paid over 20 years starting in 1437H (2016). This, along with previous GCI subscriptions and special capital increases, should lead to an additional SDR2.4 billion being paid in over the next 10 years. Shareholders have supported the bank through the regular

GCIs, albeit with a few member countries occasionally delaying their payments of capital installments.

At the end of 1436H (2015), capital overdue constituted 2.7% of total paid-up capital, up slightly from 2.2% one year earlier. It's our understanding that the increase in late payments is from smaller shareholders. In addition, as per the decision made at the Islamic Summit of August 1433H (2012), IsDB's board of governors has suspended Syria's membership in the Organization of Islamic Cooperation and all its organs, which includes IsDB.

Despite IsDB's activities in riskier countries than are typical with other 'AAA' rated MLIs, the bank's operational portfolio has performed well, and the bank has never reported a write-off of any public-sector exposures. At financial year-end 1436H (2015), IsDB reported SDR100 million in overdue obligations, equivalent to 0.9% of operating assets. However, this figure does not include the total amount of the exposure to the defaulting counterparties but rather the nonperforming portion. We understand that this figure would rise to approximately 7% if the full loan amount were included.

The bank has historically benefited from its government borrowers giving it preferred creditor treatment, and we expect that it will continue to do so. Roughly 60% of the bank's overdue loans relate to sovereign exposures in so-called special circumstances--those at war or without a functioning government.

Financial results for 1436H (2015) indicate that IsDB's total assets grew by just under 7%, which is similar to the pace of growth in 1435. Net income remained relatively flat over 1435, after falling from 1434 as revenue declined from intermediation (equivalent to interest income), reduced dividend income from the bank's equity investment portfolio, and foreign exchange losses related to a weaker euro against the U.S. dollar. We expect that this pace of growth will persist, in line with the bank's strategy.

Sovereign and Multilateral Lending Institutions

The bank's leverage has increased over the past year, with gross debt to adjusted total assets climbing to 50% from 47% owing to sukuk liabilities. Our funding and liquidity ratios for IsDB indicate that it would be able to fulfil its mandate for at least one year, even under extremely stressed market conditions.

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

Under our criteria, we do not factor in IsDB's callable capital as extraordinary shareholder support because we assess the bank's SACP at 'aaa'. Even if we were to revise the SACP downward, we would not factor in the bank's callable capital because IsDB benefits from ample cash capitalization.

Outlook

The stable outlook reflects our expectation that IsDB's financial profile will remain extremely strong over the next 24 months. We also anticipate that the bank will continue to enjoy preferred creditor treatment and other strong shareholder support.

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

We might also consider a downgrade if we were to downwardly revise our assumption about the bank benefitting from preferred creditor treatment or our assessment of the importance of the bank's role.

S&P Global Ratings: Public Ratings List

Issuer Credit Ratings -- Takafuls & Islamic Banks

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

Ratings as of Sept. 5, 2016

Sukuk currently rated by S&P Global

| Obligor | Country | Sukuk/Trust certificates | Sector | Date of Ratin | Issued (\$-eq Mn) | LT FC rating |
|---------------------------|-----------|---------------------------------------|--------|---------------|-------------------|--------------|
| Emirate of Ras Al Khaimah | UAE | RAK Capital | Gov. | 2008 | 500 | A |
| State of Qatar | QAT | SoQ Sukuk A Q.S.C. | Gov. | 2011 | 2,000 | AA |
| State of Qatar | QAT | SoQ Sukuk A Q.S.C. | Gov. | 2011 | 2,000 | AA |
| Islamic Development Bank | Saudi A. | IDB Trust Services Ltd. | Gov. | 2011 | 7,291 | AAA |
| Government of Malaysia | Malaysia | Wakala Global Sukuk Series 2 | Gov. | 2011 | 800 | A- |
| Republic of Indonesia | Indonesia | Perusahaan Penerbit SBSN Indonesia II | Gov. | 2011 | 1,000 | BB+ |
| Central Bank of Bahrain | Bahrain | CBB International Sukuk Company (No3) | Gov. | 2011 | 750 | BB |
| Abu Dhabi Commercial Bank | UAE | ADCB Islamic Finance (Cayman) Ltd. | FI | 2011 | 500 | A |
| Banque Saudi Fransi | Saudi A. | BSF Sukuk Ltd. | FI | 2012 | 750 | BBB+ |
| Axiata Group Bhd. | Malaysia | Axiata SPV2 Bhd. | Corp. | 2012 | 1,000 | BBB |
| Majed Al Futtaim | UAE | MAF Sukuk Ltd. | Corp. | 2012 | 900 | BBB |
| Saudi Electric Co. | Saudi A. | Saudi Electricity Global Sukuk Co. | Corp. | 2012 | 500 | A- |
| Saudi Electric Co. | Saudi A. | Saudi Electricity Global Sukuk Co. | Corp. | 2012 | 1,250 | A- |

S&P Global Ratings: Public Ratings List

Sukuk currently rated by S&P Global

| Obligor | Country | Sukuk/Trust certificates | Sector | Date of Ratin | Issued (\$-eq Mn) | LT FC rating |
|---|------------|---|--------|---------------|-------------------|--------------|
| Development Bank of Kazakhstan | KAZ | Development Bank of Kazakhstan Program | Gov. | 2012 | 59 | BBB- |
| Republic of Indonesia | Indonesia | Perusahaan Penerbit SBSN Indonesia III | Gov. | 2012 | 7,000 | BB+ |
| IILM | Malaysia | International Islamic Liquidity Management 2 SA | SF | 2013 | 1,850 | A-1 |
| Saudi Electric Co. | Saudi A. | Saudi Electricity Global SUKUK Co. 2 | Corp. | 2013 | 2,000 | A- |
| Dubai Electricity Water Authority | UAE | DEWA Sukuk 2013 Ltd. | Corp. | 2013 | 1,000 | BBB+ |
| Sharjah Islamic Bank | UAE | SIB Sukuk Co. III Ltd. | FI | 2013 | 500 | BBB+ |
| Albaraka Turk Katilim Bankasi AS | Turkey | ABT Sukuk Ltd. | FI | 2013 | 200 | B- |
| Aldar Properties PJSC | UAE | Sukuk Funding (No. 3) Ltd. | Corp. | 2013 | 750 | BBB |
| Emaar Properties PJSC | UAE | Emaar Sukuk Ltd. | Corp. | 2014 | 1,000 | BBB- |
| Mumtalakat | Bahrain | Bahrain Mumtalakat Holding Co. Sukuk Programme | Gov. | 2014 | 600 | BB |
| Pakistan | Pakistan | The Second Pakistan International Sukuk Company Limited | Gov. | 2014 | 1,000 | B- |
| Albaraka Turk Katilim Bankasi AS | Turkey | Bereket Varlik Kiralama A.S. | FI | 2014 | 350 | BB- |
| DIFC Investment LLC. | UAE | DIFC Sukuk. Ltd | Corp. | 2014 | 700 | BBB |
| Ooredoo (Tamweel) | QAT | Ooredoo Tamweel Ltd. | Corp. | 2014 | 1,250 | A- |
| Dubai Investment Park Dvt Co LLC | UAE | DIP Sukuk Ltd | Corp. | 2014 | 300 | BB+ |
| Saudi Electric Co. | Saudi A. | Saudi Electricity Global Sukuk Co. 3 (tranches 1 & 2) | Corp. | 2014 | 2,500 | A- |
| Damac Real Estate Development | UAE | Alpha Star Holding Ltd. *(Damac Sukuk) | Corp. | 2014 | 650 | BB |
| Hong Kong (Special Administrative Region) | HK [China] | Hong Kong Sukuk 2014 Ltd. | Gov. | 2014 | 1,000 | AAA |
| Emirate of Sharjah | UAE | Sharjah Sukuk Limited | Gov. | 2014 | 750 | A |
| The Goldman Sachs Group Inc. | U.S.A. | JANY Sukuk Company Limited | FI | 2014 | 500 | BBB+ |
| Republic of South Africa | South A. | Republic of South Africa Sukuk 1 | Gov. | 2014 | 500 | BBB- |
| Luxembourg | Luxembourg | Luxembourg Treasury Securities SA | Gov. | 2014 | 226 | AAA |
| Hong Kong (Special Administrative Region) | HK [China] | Hong Kong Sukuk 2015 Ltd. | Gov. | 2015 | 1,000 | AAA |
| Government of Malaysia | Malaysia | Malaysia Sovereign Sukuk Bhd. (Series 1 & 2) | Gov. | 2015 | 1,500 | A- |
| Petroleum National Berhad | Malaysia | Petronas Global Sukuk | Corp. | 2015 | 1,250 | A- |
| Albaraka Turk Katilim Bankasi AS | Turkey | Albaraka Sukuk Ltd. | FI | 2015 | 250 | B- |
| International Finance Corp. | U.S.A. | IFC Sukuk Co. | Gov. | 2015 | 100 | AAA |
| Damac Real Estate Development | UAE | Alpha Star Holding Ltd. II (Damac Sukuk) | Corp. | 2015 | 100 | BB |
| Ezdan Sukuk Company Ltd. | QAT | Ezdan Sukuk Company Ltd. | Corp. | 2016 | 500 | BBB- |
| Hilal Services Ltd. | Saudi A. | Hilal Services Ltd. | Gov. | 2016 | 300 | AA |
| Emirate of Sharjah | UAE | Sharjah Sukuk 2 Ltd. | Gov. | 2016 | 500 | A |
| Government of Malaysia | Malaysia | Malaysia Sukuk Global Berhad | Gov. | 2016 | 1,500 | A- |

Glossary Of Islamic Finance Terms: August 2015 Update

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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.

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.

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.

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 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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