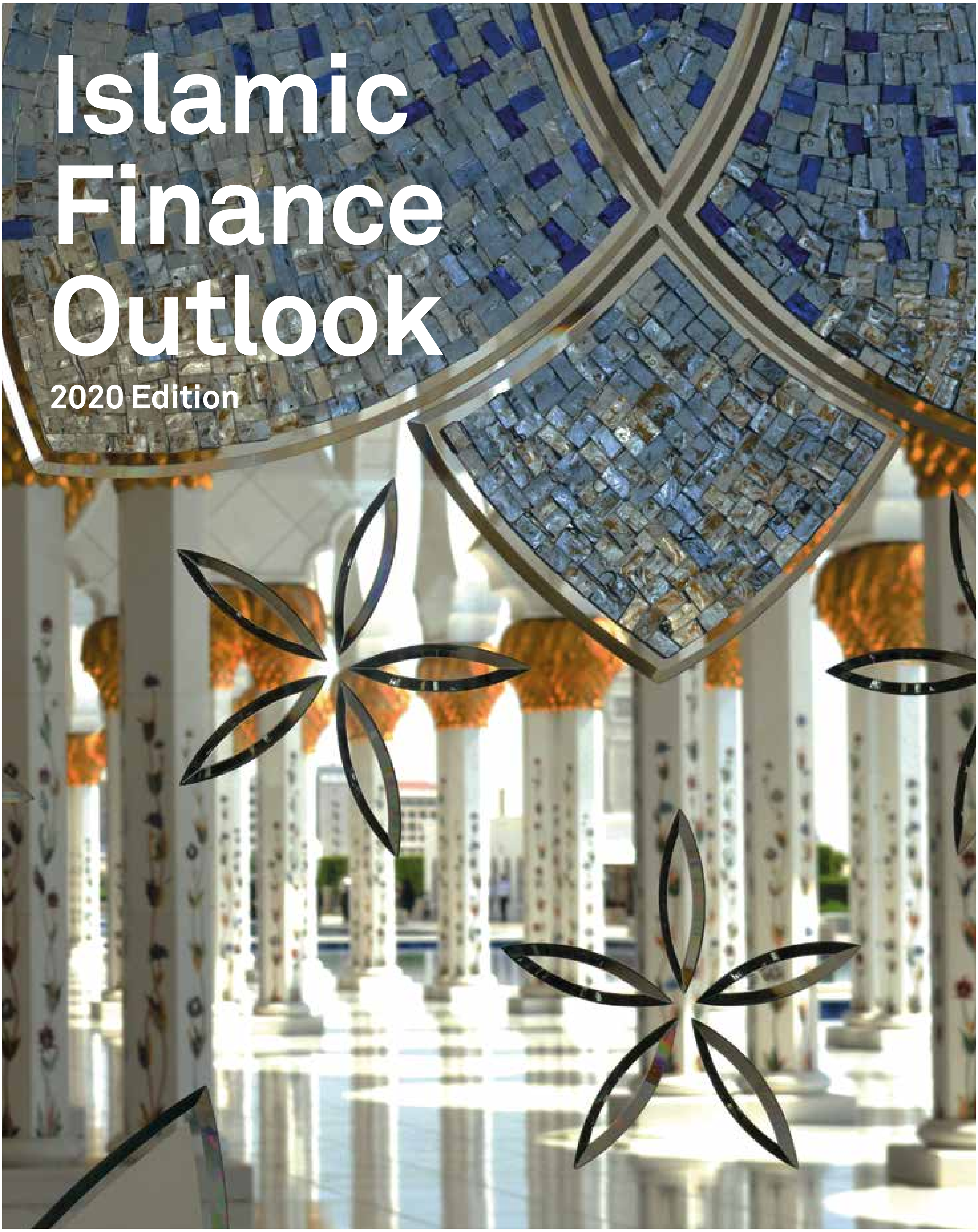
Islamic Finance Outlook

2020 Edition



S&P Global
Ratings

Contents
2020

Islamic Finance 2020

THREE ACCELERATORS TO GET BACK TO STRONG GROWTH

Dr Mohamed Damak
Senior Director
& Global Head of Islamic Finance

S&P Global Ratings believes the global Islamic finance industry will continue to expand slowly in 2019-2020. Total assets increased by only about 2% in 2018, compared with 10% in 2017, after a decline in the sukuk market, which saw strong performance the previous year. We do not expect the market to fare much better in the next two years given the significant volatility in key parameters such as oil prices and geopolitical risk. The growth of banking assets has also slowed down in almost all core Islamic finance markets. Turkey and Iran lead this decline under a trend that we expect will continue in the next 12-24 months. As the economic cycle might turn at some stage, we believe a low-single-digit growth rate over the next two years is a fair assumption.

We see three potential accelerators that could get the industry back to the days of strong growth: Inclusive standardization, financial technology (fintech), and environmental, social and governance (ESG) opportunities.

1- Inclusive standardization: We define this as the standardization of Sharia interpretation and legal documentation that factors in the requirements of all stakeholders. Ideally, the process of issuing sukuk should be equivalent from a time, effort, and price perspective to issuing a conventional bond. For issuers, this would mean taking a set of standard legal documents, plugging in its underlying assets, and going to market. For investors, it would mean the capacity to understand the risks related to their instruments. For Sharia scholars, it would mean factoring the requirements of the market and creating some room for innovation. The different standard setters of the industry--the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic Financial Service Board (IFSB), and the International Islamic Financial Market (IIFM) -are working together to advance this agenda. We believe that regulators, sukuk issuers, and investors should also have their say.

2- Fintech: Fintech could help the industry by facilitating easier and faster transactions, improving the traceability and security of transactions using blockchain, enhancing the accessibility of Islamic financial services, and improving governance. Of specific note, blockchain could resolve three challenges related to sukuk issuance and management. These include the traceability of underlying assets to understand better the risk, the traceability of cash flows for prompt corrective action in case of underperformance, and the traceability of investors. This, together with smart-contract protocols, could create faster and even out-of-court resolutions for sukuk disputes.

3- ESG opportunities: The goals or objectives (maqasid) of Sharia share some links with ESG considerations and the broader aim of sustainable finance. For example, Islamic finance's goal to protect life aligns with sustainable finance principles, which emphasize environmental and social protection. Green sukuk is an example of instruments that could be used to finance environmentally friendly projects. On the governance side, Islamic banks and instruments are typically subject to an additional layer of governance compared with their conventional counterparts (the Sharia governance). However, for now, this additional layer has not enhanced market discipline vis-à-vis Islamic financial institutions and instruments. External audit and higher disclosure requirements could make this happen. On the social side, a number of instruments already exist and their size is reportedly substantial. However, they have not been leveraged in modern Islamic finance in a transparent, systematic manner. These products could make a difference when it comes to socially responsible financing. We think a proper governance framework for their use will be required to prevent the risk of diverting these instruments from their original purpose.

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

We hope you enjoy the 2020 edition of our "Annual Outlook For Islamic Finance," and as always, we welcome and encourage your feedback about our research and insights.

التمويل الإسلامي 2020: ثلاثة عوامل يمكن أن تُسهم في عودة القطاع للنمو القوي

د. محمد دمق

مدير أول والرئيس العالمي للتمويل الإسلامي

وكالة «إس آند بي جلوبال للتصنيفات الائتمانية»

تعتقد وكالة «إس آند بي جلوبال للتصنيفات الائتمانية» بأن قطاع التمويل الإسلامي سيواصل نموه ببطء في الفترة الممتدة ما بين 2019–2020. فقد ارتفع إجمالي أصول القطاع بنسبة 2% فقط في العام 2018، مقارنةً بـ 10% في العام 2017، بعد التراجع في سوق الصكوك، الذي شهد أداءً قوياً في السنة الماضية. لا نتوقع بأن يحقق السوق أداءً أفضل بكثير في العامين المقبلين نظراً للتقلبات الكبيرة في مقاييس رئيسية مثل أسعار النفط والمخاطر الجيوسياسية. كما تراجع نمو الأصول المصرفية في معظم البلدان الأساسية للتمويل الإسلامي. وكان الجزء الأكبر من التراجع من نصيب تركيا وإيران، التوجه الذي نتوقع استمراره خلال الأشهر 12–24 المقبلة. ومع احتمال حدوث تحولٍ في الدورة الاقتصادية في مرحلة ما، نعتقد بأنه من المنطقي توقع معدّل نمو منخفض مكوّن من رقم واحد خلال العامين المقبلين.

نرى بأن هناك ثلاثة عوامل يمكنها أن تسهم عودة القطاع للنمو القوي هي التوحيد الشامل للمواصفات، والتكنولوجيا المالية، وفرص الحوكمة والبيئة والمسؤولية الاجتماعية.

العامل الأول: التوحيد الشامل للمواصفات: نعرّف ذلك بتوحيد تفسير الأحكام الشرعية والوثائق القانونية الذي يأخذ بعين الاعتبار متطلبات جميع أصحاب المصلحة. يجب أن تكون عملية إصدار الصكوك مشابهة لعملية إصدار السندات التقليدية من حيث استهلاك الوقت والجهد والتكلفة. وهذا يعني إجراءات أقل تعقيداً ووقتاً أقل لعملية الإصدار في السوق بالنسبة للمُصْدرين، أما بالنسبة للمستثمرين فالتوحيد الشامل للمواصفات يعني القدرة على فهم المخاطر المرتبطة بأدواتهم المالية. وبالنسبة لعلماء الشريعة فإن التوحيد الشامل للمواصفات يعني الأخذ بعين الاعتبار بمتطلبات السوق وإفساح المجال أمام الابتكار. وتعمل مختلف الجهات المسؤولة عن وضع المعايير في القطاع ممثلة بهيئة المحاسبة والمراجعة للمؤسسات المالية الإسلامية (أيوفي)، ومجلس الخدمات المالية الإسلامية، والسوق الإسلامية المالية الدولية معاً لتحقيق هذه الأهداف. ونعتقد بأن الجهات التنظيمية ومُصْدري الصكوك والمستثمرين جميعاً يجب أن يكون لهم رأيهم بهذا الخصوص.

العامل الثاني: التكنولوجيا المالية

يمكن للتكنولجيا المالية أن تساعد في فتح آفاق جديدة لفرص النمو من خلال تسهيل وتسريع تنفيذ المعاملات وتحسين تتبعها ومستوى الأمان باستخدام تكنولوجيا البلوكشين وتحسين الوصول إلى خدمات التمويل الإسلامي وتعزيز الحوكمة. ويمكن لتكنولوجيا البلوكشين، على وجه الخصوص، حل ثلاثة تحديات مرتبطة بإصدار وإدارة الصكوك تتضمن متابعة الأصول الأساسية، مما سيساعد المستثمرين على فهم أفضل للمخاطر، ومتابعة التدفقات النقدية لاتخاذ إجراءات تصحيحية فورية في حال كان الأداء دون التوقعات، ومتابعة المستثمرين الحاملين للصكوك. وبالإضافة إلى بروتوكولات العقود الذكية فإن ذلك يمكن أن يضع حلولاً أسرع للنزاعات المتعلقة بالصكوك أو حتى التوصل إلى حل دون اللجوء للقضاء.

العامل الثالث: فرص ممارسات الحوكمة والبيئة والمسؤولية الاجتماعية

تتقاسم أهداف أو مقاصد الشريعة بعض الروابط مع أهداف الحوكمة والبيئة والمسؤولية الاجتماعية والهدف الأوسع للتمويل المستدام. على سبيل المثال، يتماشى هدف التمويل الإسلامي لحماية الحياة مع مبادئ التمويل المستدام، والتي تؤكد على حماية البيئة والمسؤولية الاجتماعية. وتعتبر الصكوك الخضراء إحدى الأدوات المالية التي يمكن استخدامها لتمويل المشاريع الصديقة للبيئة. من ناحية الحوكمة، تكون البنوك والأدوات الإسلامية عادةً خاضعة لمستوى إضافي من الحوكمة مقارنةً بنظيراتها التقليدية. ولكن حتى الآن لم يُسهم هذا المستوى الإضافي من الحوكمة في تحسين الانضباط السوقي للمؤسسات المالية والأدوات المالية الإسلامية. ويمكن تحقيق ذلك من خلال إجراء تدقيق شرعي خارجي وفرض المزيد من متطلبات الإفصاح. أما من جانب المسؤولية الاجتماعية، فهناك أدوات مالية مسؤولة اجتماعياً في قطاع التمويل الإسلامي وحجمها كبير بحسب تقارير، ولكنه لم يتم الاستفادة منها في قطاع التمويل الإسلامي الحديث بطريقة شفافة ومنتظمة، ويمكن لهذه المنتجات أن تحدث فرقاً عندما يتعلق الأمر بالتمويل المسؤول اجتماعياً. نعتقد بأن وجود نظام حوكمة مناسب لاستخدام تلك المنتجات سيكون مطلباً للوصول إلى هذا الهدف. ونظراً لحجمها الكبير فإن ذلك قد يدفع المستخدمين إلى تحويل هدف هذه الأدوات عن غرضها الأصلي.

وبفضل المبادئ الأساسية للتمويل الإسلامي فإن القطاع يمكن أن يشارك في تحقيق ازدهار مشترك ونمو أكثر شمولاً للمجتمع، ولكن لتعزيز هذه المشاركة يحتاج القطاع أكثر من أي وقت مضى لإجراء إصلاحات قوية وحاسمة. قبل نحو 50 عاماً، نجح مروجو قطاع التمويل الإسلامي في تشكيل قطاع جديد، ونحن نعتقد بأن المسؤولية اليوم تقع على عاتق جميع أصحاب المصلحة للعمل على تمكين هذا القطاع من الوصول إلى أقصى إمكاناته.

نأمل بأن تنال نسخة "**التوقعات السنوية للتمويل الإسلامي للعام 2020**" إعجابكم، ونرحب دائماً بآرائكم وتعليقاتكم حول تحليلاتنا وأبحاثنا.

Dubai International Financial Centre

This book is supported by Dubai International Financial Centre (DIFC), in conjunction with S&P Global Islamic Finance Conference in Dubai on 17 September, 2019.

Innovation dominated the sentiment surrounding the Islamic Finance sector in 2018, however this year has brought a greater need for simplification, alongside invention, in order to sustain growth and longevity.

The Middle East, Africa and South Asia (MEASA) region continues to be a steady player in an industry worth more than $2.1 trillion, fueled by the growing popularity of Islamic Banking across the region. Sharia-compliant assets represent 14% of total banking assets in MEASA and 25% of banking assets in the GCC, suggesting that Islamic banking continues to be systemically important in these countries. Consequently this year, MEASA's leading financial hub, Dubai International Financial Centre (DIFC), is set to welcome Malaysia's largest lender and the fifth largest sharia-compliant bank in the world, Maybank Islamic Berhad, to the Centre. The move will bridge two of the world's biggest centres for Islamic finance, allowing it to service the GCC market and access one of the world's leading exchanges for sukuk, whilst aligning on financial infrastructure and standardisation in the sector.

Alongside Islamic Banking, the FinTech disruption remains a great opportunity for the sector to streamline services and attract new segments, with the key being digital-savvy millennials. Younger customers are expected to play a crucial role in the growth of Islamic finance and expand its customer base in the future, with the younger segment expecting to contribute to as much as 75 per cent of total bank revenue by 2030. This is an area that DIFC has been investing in heavily, with its constantly growing FinTech ecosystem contributing to the UAE's position as the fourth largest Islamic FinTech hub in the world. The Centre has become a nexus for Islamic Finance institutions to engage with innovative start-ups, with the DIFC's FinTech Hive accelerator now partnering with over 35 organisations, including the Dubai Islamic Economy Development Centre, Emirates Islamic Bank, Dubai Islamic Bank and Abu Dhabi Islamic Bank.

Finally, as we share the common goal of building a strong and sustainable financial services sector in Dubai, the synergies between Environment, Social and Governance (ESG) and Islamic Finance have been a natural fit and a ripe opportunity to lead the way in ethical solutions. DIFC and DFM (Dubai Financial Market) have brought together representatives of leading banks, financial institutions, as well as public and private companies in the first Dubai Sustainable Finance Working Group launched early this year. The group will focus on combining Dubai's finance sector's initiatives to create a sustainable financial hub in the region in line with the UAE Sustainable Development Goals 2030 and Dubai's Strategic Plan 2021, encouraging the use of green financial instruments and responsible investing.

As the DIFC progresses in driving the future of finance, Islamic Finance and the principals that guide it will continue to play a significant role in supporting sustainable growth within the regional financial services sector.

Islamic Finance 2019-2020: One Industry, Three Accelerators

Primary Credit Analyst:
Mohamed Damak
Dubai
(971) 4-372-7153
mohamed.damak@spglobal.com

Secondary Contact:
Dhruv Roy
Dubai
(44) 20-7176-6709
dhruv.roy@spglobal.com

Additional Contact:
Financial Institutions Ratings Europe
FIG_Europe@spglobal.com

S&P Global Ratings believes the global Islamic finance industry will continue to expand slowly in 2019-2020. However, inclusive standardization, financial technology (fintech), and opportunities related to the industry's social role could help accelerate growth in the next few years.

In particular, standard Sharia interpretation and legal documentation could simplify sukuk issuance and increase its appeal for issuers, while leaving some room for innovation. Fintech could stimulate growth by making transactions quicker, more secure, and easier to implement. And we believe the social role of Islamic finance could unlock new growth opportunities as core markets implement the U.N. Sustainable Development Goals, and issuers and investors become more sensitive to environmental, social and governance (ESG) issues.

Key Takeaways

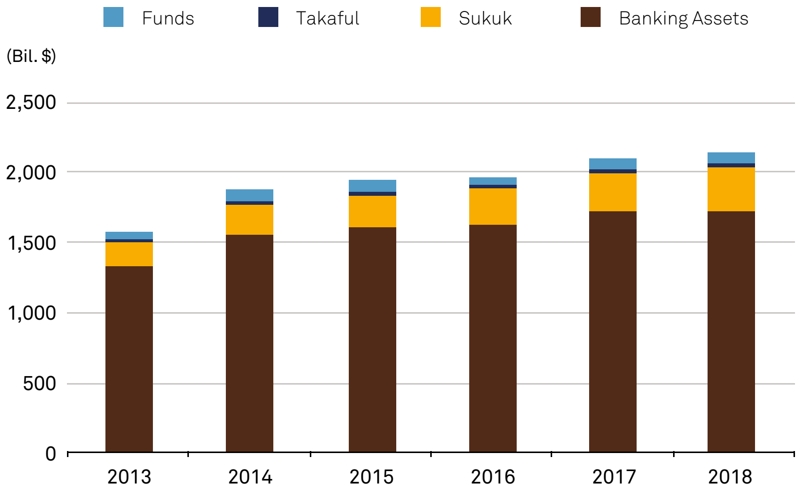
- We expect the Islamic finance industry to show only about 5% growth in 2019-2020, owing to tepid economic conditions in certain core markets.
- Inclusive standardization, fintech, and a greater focus on the social role of Islamic finance could return the industry to the days of double-digit growth.
- However, this will rely on coordination between different stakeholders.

Geopolitical And Other Factors To Hold Back Growth Through 2020

We believe the Islamic finance industry will continue to grow slowly in 2019-2020. It expanded by about 2% in 2018 compared with 10% the previous year, according to our estimates (see chart 1), with strong support from the sukuk market. In 2017, most of the growth stemmed from jumbo sukuk issuances in some Gulf Cooperation Council (GCC) countries, but this was followed by an about 5% reduction in issuances in 2018. In 2019, we do not expect the market to fare much better given the significant volatility in key parameters such as oil prices and geopolitical risk.

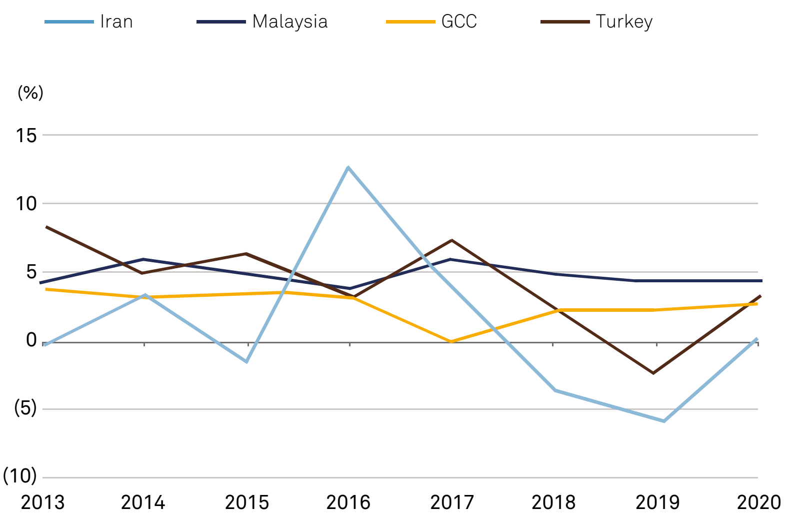
The growth of banking assets has also slowed down in almost all core Islamic finance markets. Of specific note, Turkey and Iran lead the decline under a trend that we expect will continue in the next 12-24 months. Malaysia, Indonesia, and the GCC countries were among the few sources of industry growth. As the economic cycle might turn at some stage, we believe a low-single-digit growth rate over the next two years is a fair assumption. However, we see three potential accelerators in the next few years: inclusive standardization, fintech, and the social role of Islamic finance.

Chart 1 - Islamic Finance Is A $2.1 Trillion Industry With Stagnating Growth



Source: Central Banks, Islamic Financial Service Board, Eikon, S&P Global Ratings.

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



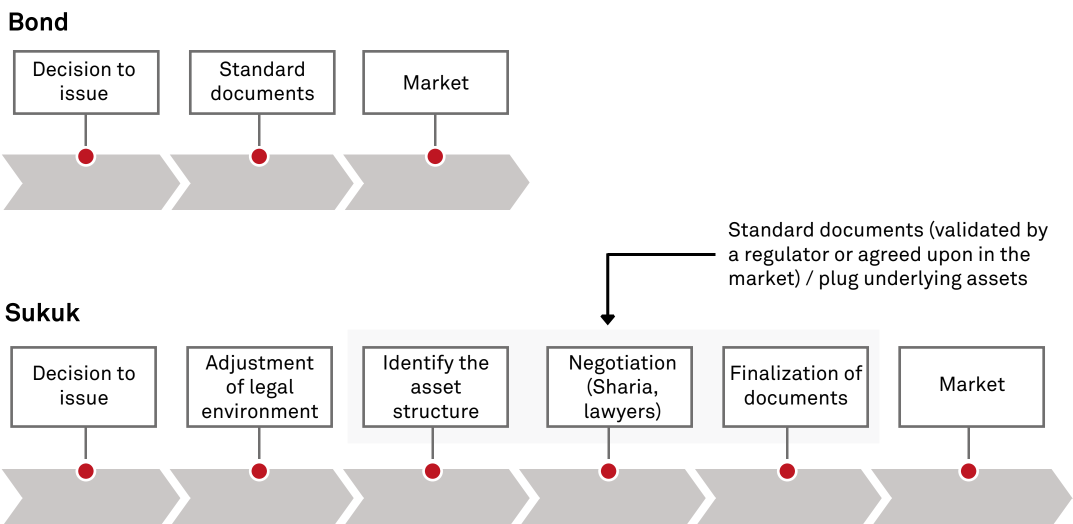
GCC--Gulf Cooperation Council. Source: S&P Global Ratings, International Monetary Fund.

The First Accelerator: Inclusive Standardization

In our view, a prerequisite for faster growth is inclusive standardization. We define this as the standardization of Sharia interpretation and legal documentation that factors in the requirements of all the stakeholders. For issuers, inclusive standardization would mean less complexity and time needed to put together their sukuk and tap the market. Ideally, an issuer would be able to take a set of standard legal documents, plug-in its underlying asset, and go to the market. The process should be equivalent from a time, effort, and price perspective to issuing a conventional bond.

For investors, inclusive standardization means the capacity to understand the risks related to their instruments and avoid situations where they lose money because they, or any other stakeholders, have interpreted the legal provisions of sukuk contracts in a specific way. For Sharia scholars, inclusive standardization means factoring the requirements of the market and creating some room for innovation. The different standard setters of the industry--the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic Financial Service Board (IFSB) and the International Islamic Financial Market (IIFM)--are working together to advance this agenda. We believe that regulators, sukuk issuers, and investors should also have their say, and a more inclusive consultative process can help the market move forward more quickly. This process would ultimately lead to the standardization of the full spectrum of sukuk--from fixed-income to equity-like instruments.

Chart 3 - Inclusive Standardization And Reduction Of Complexity



Source: S&P Global Ratings.

The Second Accelerator: Fintech Disruption

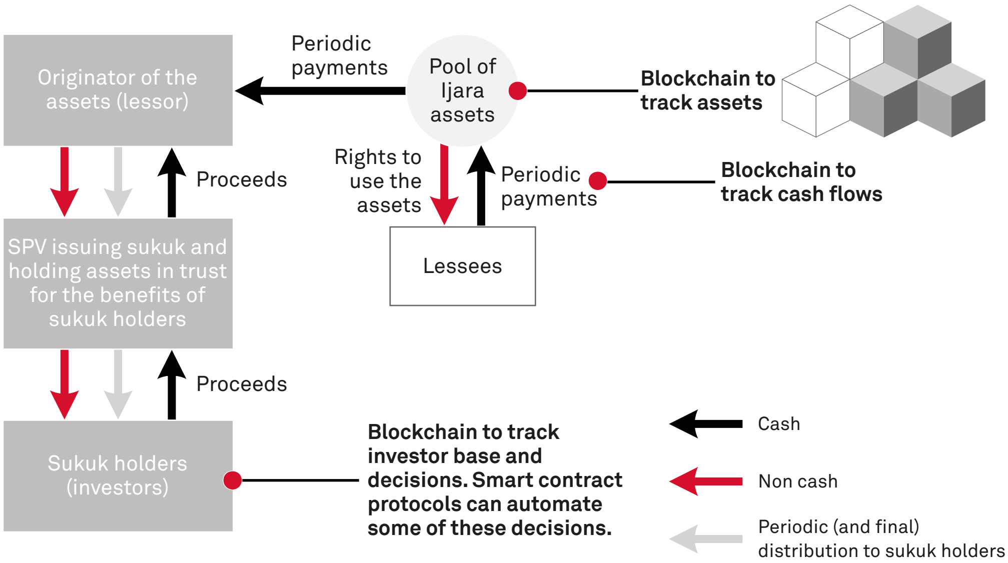
Market participants typically see fintech as a risk for the financial industry, but we think fintech could also help unlock new growth opportunities through the faster execution and better traceability of transactions. We believe that fintech could help the industry in four ways:

Ease and speed of transactions. This is particularly true for payment services and money transfers. Islamic finance industry players can benefit from the possibilities fintech and other innovations offer to enhance their services and attractiveness. Technology could also reduce costs, allowing the redeployment of staff to higher added-value operations.

Traceability of transactions. Using blockchain could help reduce the industry's exposure to risks related to transaction security or identity theft. It could also disrupt the way sukuk are issued and managed. Blockchain could resolve three challenges related to sukuk issuance and management:

- The traceability of underlying assets, which would help investors to better understand the risks related to sukuk in their portfolios.
- The traceability of cash flows, which would help issuers to implement prompt corrective actions if one of the underlying assets underperforms.
- The traceability of investors, which together with smart-contract protocols could create faster, and even out-of-court, resolutions for sukuk disputes.

Sukuk And Blockchain: A Perfect Match?



Source: S&P Global Ratings.

Greater accessibility of Islamic finance services. Fintech could also help the industry broaden its reach and tap new customer segments currently excluded from the banking system. For example, mobile banking for clients in remote areas, or the provision of products such as crowdfunding for affordable housing or small and midsize enterprises (SMEs), could provide new growth prospects. However, this assumes access to a minimum amount of physical and nonphysical infrastructure.

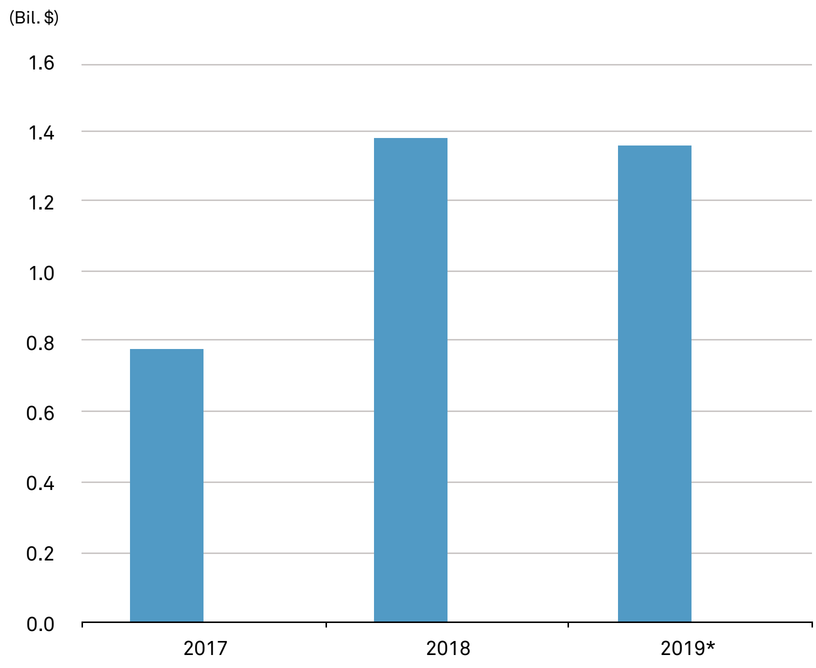
Improved governance. Regulatory technology could help the Islamic finance industry with more robust tools to achieve compliance with regulations and Sharia requirements, assuming agreed Sharia standards are in place. It could also minimize the reputation risk related to a potential breach of Sharia requirements, and free up Sharia scholars to focus on innovation.

A prerequisite for fintech to enrich the Islamic finance industry is the provision of an adequate physical infrastructure and the implementation of the necessary supervision and regulatory framework. This is why several regulators and authorities in the GCC and elsewhere have launched incubators or specific regulatory "sandboxes"--where fintech companies can test innovations in the real market but in a restricted regulatory environment.

The Third Accelerator: ESG Opportunities

Islamic finance, which must abide by the goals or objectives (maqasid) of Sharia, shares some links with ESG considerations and the broader aim of sustainable finance. As regulators and policymakers around the world seek to establish a more sustainable, stakeholder-focused, and socially responsible financial system, we see areas where Islamic finance and sustainable finance align. For example, Islamic finance's goal to protect life aligns with sustainable finance principles, which emphasize environmental and social protection. These include either refraining from developing or financing operations that could harm the environment or the health or wellbeing of humankind. Green sukuk is an example of instruments that can be used to finance environmentally friendly projects (see chart 5 and Related Research).

Chart 5 - Green Sukuk Issuance Has Almost Equaled The 2018 Total So Far This year



*Year to date. Source: S&P Global Ratings.

On the governance side, Islamic banks and instruments are typically subject to an additional layer of governance compared with their conventional counterparts. This typically comes in the form of approval by Sharia boards, which ensure the conformity of these products with Sharia at any point during their life cycle. However, for now, this additional layer of governance has not enhanced market discipline vis-à-vis Islamic financial institutions and instruments. This is because there is currently very limited recourse to external Sharia audits and the publishing of the audit results.

We believe the social aspect has been cast somewhat to the back seat. The underlying principles are socially focused and a number of instruments already exist, but they have not been leveraged in modern Islamic finance in a transparent, systematic manner. This may be because Islamic banks, as issuers themselves, do not appear to focus on their own social performance.

From the perspective of financing activities, the lack of visibility of the 'S' factor is underpinned by Islamic banks' commercial interests, including financial performance, and is not because of a lack of instruments or products. Indeed, socially responsible products do exist in Islamic finance and their size is reportedly substantial. These products could make a difference when it comes to socially responsible financing. We think a proper governance framework for their use will be required to reach this objective. Because the amounts are high, users can be tempted to divert these instruments from their original purpose.

How Will These Factors Affect Our Ratings In Islamic Finance

We believe fintech will have only a marginal influence on our Islamic bank and sukuk ratings over the next two years. We consider that Islamic banks will be able to adapt to their changing operating environment through a combination of collaboration with fintech companies and cost-reduction measures. We also believe that regulators across the wider Islamic finance landscape will continue to protect the financial stability of their banking systems. Furthermore, we think that blockchain could help the operational management of sukuk but will not induce any changes in the legal substance of the transactions.

We incorporate ESG considerations into our ratings and analytics of Islamic financial institutions and sukuk, in a similar manner as for conventional issuers and issues (see Related Research). For sukuk ratings, the ESG considerations would generally be reflected in the sponsor rating. For sovereign sukuk, for example, institutional quality and governance effectiveness is a key factor for the rating of the sovereign sponsor. Similarly, for banks, we do take into consideration deficiencies in the overall quality of a banking system's governance and transparency in our Banking Industry Country Risk Assessment. The positive or negative effect could also be reflected in the individual assessment of a bank's management and strategy quality, or through its potential exposure to losses on its financing or investment portfolios because of ESG-related considerations, such as climate change. For takaful companies, risks inherent to the insurance markets in which the company operates, or specific risks undertaken by the insurance company (such as exposure to climate change), are factored in the macro assessment of the insurance company.

Related Research

- The Sukuk Market Starts 2019 Well, But Activity Might Taper Off, June 16, 2019
- IFSB Proposal On Sharia-Compliant Lender Of Last Resort Facilities: Moving In the Right Direction, May 20, 2019
- Islamic Finance And ESG: The Missing 'S', May 20, 2019
- GCC Islamic Banks Will Likely Stay Resilient In 2019-2020, May 6, 2019
- S&P Global Ratings Launches Its ESG Evaluation, April 11, 2019
- The ESG Advantage: Exploring Links To Corporate Financial Performance, April 8, 2019
- Countdown To Brexit: Implications Of A No-Deal Brexit For Islamic Finance, Feb. 18, 2019
- AAOIFI's Proposed Standards For Governance Of Sukuk Might Open The Door To Unforeseen Risks, Jan. 21, 2019
- The Rise Of ESG In Fixed Income, Sept. 10, 2018

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

The Sukuk Market Starts 2019 Well, But Activity Might Taper Off

Primary Credit Analyst:

Mohamed Damak
Dubai
(971) 4-372-7153
mohamed.damak
@spglobal.com

Secondary Contact:

Dhruv Roy
London
(44) 20-7176-6709
dhruv.roy
@spglobal.com

High levels of liquidity in Indonesia, Turkey's efforts to tap all available financing sources, and the return of Qatari and Saudi Arabian issuers to the market have boosted issuance of sukuk 17.6% in the first five months of 2019. Foreign currency issuances also increased 15.6% during the period, explained primarily by Turkey's issuances but also issuances by Qatari banks and Saudi corporates.

S&P Global Ratings now anticipates total sukuk issuance of $115 billion this year, including $32 billion of foreign currency issuances, which is the upper limit of our previous forecast (see "Oil Prices Will Help Shape Sukuk Markets' Performance in 2019," published Jan. 15, 2019, on RatingsDirect). However, this represents little-to-no growth on the $114.8 billion seen in 2018, with selective investors, worsening geopolitical stability in the Middle East, and challenges inherent to sukuk likely to hold back the market. In addition, Gulf Cooperation Council (GCC) issuers continue to prefer conventional financing, despite their significant needs, with only a handful tapping the sukuk market so far this year.

Key Takeaways

- We now expect sukuk issuance to reach $115 billion this year, the upper end of our 2019 forecast, assuming oil prices average $60 a barrel and no further spike in geopolitical risk.

- This follows the good performance of the sukuk market in first-half 2019, led by Indonesia, Turkey, Saudi Arabia, and Qatar.

- We believe standardization efforts and the creation of local currency sukuk markets in the GCC could enhance the industry's value proposition and stimulate growth.

What's Behind The Good Performance So Far?

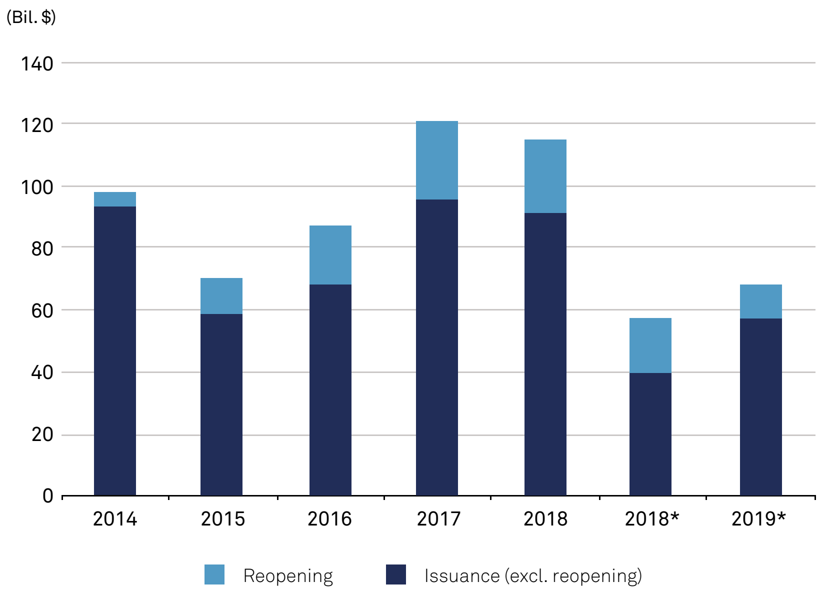
Total sukuk issuance increased to $67.9 billion in the first five months of 2019, compared with $57.7 billion over the same period in 2018 (see chart 1). Sukuk issuances from Indonesia, Turkey, and to a lesser extent Saudi Arabia and Qatar, supported the activity of the sukuk market.

Of particular note, the Central Bank of Indonesia started to offer sukuk as liquidity management instruments for its financial institutions. This resulted in an issuance total of about $7.6 billion and led to a sharp increase in issuance volumes out of Indonesia. The other noticeable contributor was Turkey, where issuers (primarily sovereign and financial institutions) tapped the market for $5.7 billion in the first five months of 2019, compared with $1.6 billion in the same period in 2018. Turkish issuers have been under significant pressure over the past several months given their significant external debt and declining rollover ratios. They are, therefore, actively tapping all the available pockets of liquidity including the sukuk market.

In the GCC, Qatari issuers returned to the market through sovereign and bank issuances and a couple of Saudi corporates tapped the market for relatively large foreign-currency-denominated issuances (see chart 2). In contrast, Bahrain, the United Arab Emirates (UAE), and Malaysia saw a drop in issuance volumes. In Bahrain, the government had less need to tap capital markets as funds from the $10 billion GCC support package began to be disbursed. For the UAE, the drop came because corporates front-loaded their issuance programs in 2018 to prepare for less supportive market conditions.

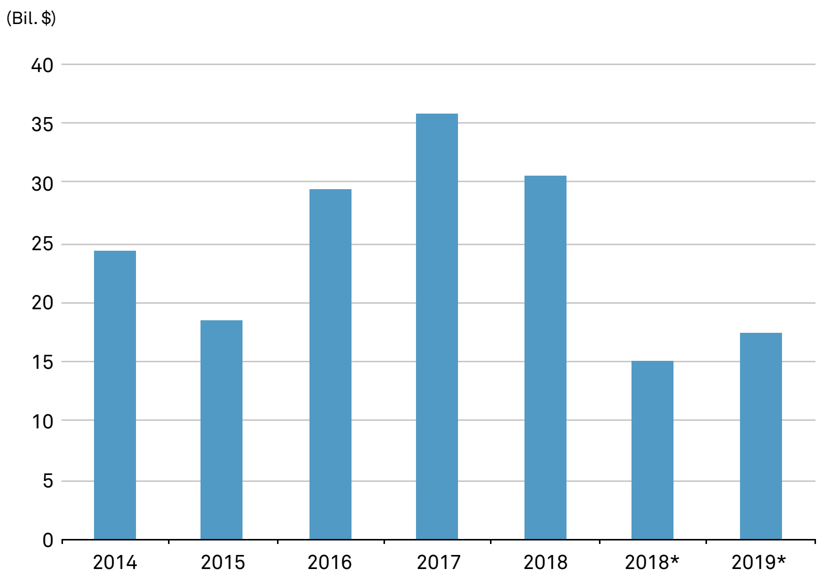
Total sukuk issuance dropped in Malaysia due to lower sovereign activity. This was partly compensated by issuances from the central bank. Overall, these developments resulted in a slightly more balanced market structure by geography (see chart 3).

Chart 1 - The Sukuk Market Performed Well In The First Five Months Of 2019



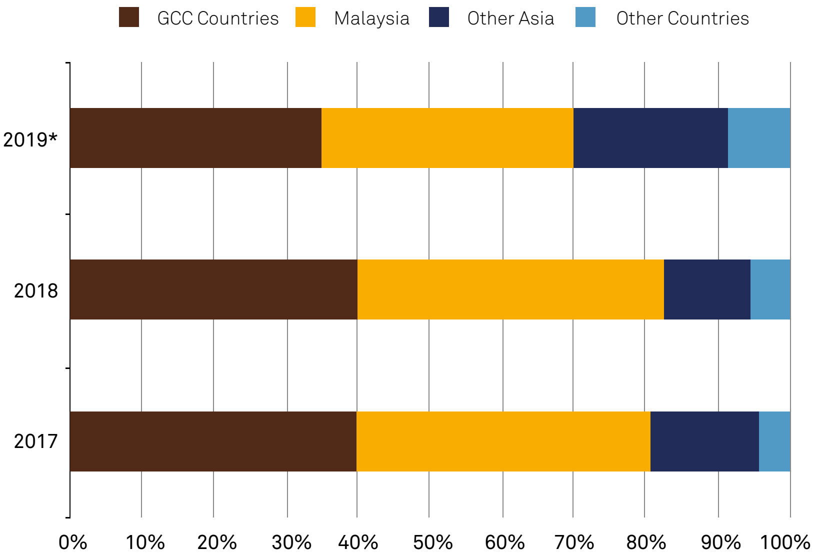
*First five months of the year. Source: S&P Global Ratings, Eikon.

Chart 2 - Foreign Currency Sukuk Issuance Is On The Up In 2019



*First five months of the year. Source: S&P Global Ratings, Eikon.

Chart 3 - 2019 Has So Far Seen A More Balanced Geographic Distribution Of Sukuk Issuance



*First five months of the year. Source: S&P Global Ratings, and Eikon.

Why We Aren't Changing Our Market Outlook

The market has seen an uptick in the first five months of the year, but we think it will at best reach the same volumes seen in 2018. We see several reasons for this:

Issuers in the GCC continue to prefer conventional instruments. The number of conventional issuances continued to increase in first-half 2019. Sukuk are more complex instruments to issue compared with conventional bonds. Moreover, the less developed nature of local capital markets in the GCC means that many issuers prefer the international capital market. Sukuk reopening (or issuance under an unlimited local currency program) in Saudi Arabia continued to support the GCC contribution to the global sukuk market. Saudi issued more than $9 billion of sukuk in the first five months of 2019. The standardization of legal documents and Sharia interpretation, together with a clear roadmap for the development of local capital markets in the region, would be a game changer.

Geopolitical risk is returning to the front seat. Tensions in the Gulf increased in May 2019 after sanction exemptions for countries buying oil from Iran ended. Since then, Iran has been accused of retaliating by allegedly damaging infrastructure and commercial shipping vessels in the region. A few additional attacks on GCC countries' assets also took place recently. Moreover, Iran is now threatening to restart its nuclear program. In our base case, we do not expect direct military conflict between the U.S. and Iran or their regional allies. Furthermore, we expect the Strait of Hormuz to remain open. That said, we see the possibility of tensions increasing further between the respective regional allies of Iran and the U.S., with possible spillover effects in Iraq, Syria, and Yemen.

Unpredictability in the region could increase should Russian support for Iran become more pronounced. In the short term, ongoing or rising tensions could result in higher oil prices and increasing fiscal revenue for the oil-exporting countries. If tensions do not abate, this additional revenue could be offset by a further increase in funding costs, reduced appetite for instruments coming from the GCC region, or major foreign funding outflows.

Oil price volatility remains a significant determinant. Depending on how the geopolitical situation unfolds, oil prices might increase, resulting in lower financing needs for GCC governments. We continue to assume the Brent oil price will average $60 a barrel (/bbl) for 2019. This would likely mean higher financing requirements for GCC governments compared with 2018, when Brent averaged about $72/bbl. Our assumptions are broadly in line with the current oil price.

Investors are becoming more selective. That the U.S. Federal Reserve has paused its cycle of rate hikes and the European Central Bank is maintaining lower interest rates for longer is helpful for global liquidity. However, investors are becoming more selective because they are concerned about the underlying reasons for these changes in global monetary policy. That means cost of funding will remain higher than it used to be and liquidity channeled from the developed market to the sukuk market will reduce.

Market Innovation Continues

In the first five months of 2019, we have observed a few interesting trends

Green sukuk interest. We have seen some interest in tapping the nascent green sukuk market, as the industry realizes its potential contribution to sustainable finance. Both the government of Indonesia and UAE-based diversified group Majid Al Futtaim issued green sukuk in first-half 2019 for a total of $1.35 billion. This figure is still small compared with $168 billion of issuance in the global green bond market in 2018, but interest is increasing. Green sukuk have reportedly allowed issuers to access not only the pool of conventional investors interested in green projects, but also Islamic investors. This could lead to potential excess demand and better financing conditions. Given the rapid increase in energy demand and the objective of shifting energy provision to greener sources in some core Islamic finance countries, particularly Malaysia, the UAE, and Saudi Arabia, the opportunities for green sukuk appear significant.

Mudaraba-murabaha structure. We have observed the use of a new variation of this structure to resolve issues related to the potential negative interference of the mudaraba contract with the murabaha one. Saudi Telecom Company utilized a restricted mudaraba contract where the underlying assets are leased to the sponsor of the sukuk (Saudi Telecom), thereby recreating the missing contractual obligations link in other mudaraba-murabaha transactions. We believe such innovation could reassure investors, who were expressing concerns regarding other mudaraba-murabaha structures.

Potential blockchain applications. The use of blockchain and smart contract protocols could help the market to expand more quickly, especially if it makes the process of sukuk issuance smoother and clarifies responsibilities under different scenarios of issuance or resolution. Blockchain could help resolve challenges related to the traceability of assets to help investors understand the risks related to their instruments over time. Blockchain could also improve the traceability of cash flows, while smart contract protocols help the implementation of prompt corrective action if one of several assets are not performing up to expectations. They could even provide out-of-court resolution for sukuk disputes because the resolution path will be coded under different scenarios in the smart contract protocols.

Related Research

- Credit FAQ: How U.S.-Iran Tensions Might Affect Gulf Sovereign Ratings, June 11, 2019
- Oil Prices Will Help Shape Sukuk Markets' Performance In 2019, Jan. 15, 2019
- Why The Global Sukuk Market Is Stalling In 2018, June 19, 2018
- The Future Of Banking: Islamic Finance Needs Standardization And Fintech To Boost Growth, April 16, 2018

This report does not constitute a rating action.

Guidance: Methodology For Rating Sukuk

Overview And Scope

This article provides additional information and guidance relating to our criteria article, "Methodology For Rating Sukuk," published on Jan. 19, 2015. This article should be read in conjunction with the criteria. For further explanation of guidance documents, see the description at the end of this article.

Guidance

The purpose of this guidance document is to clarify how S&P Global Ratings applies section IV.1. "Treatment Of Total Loss Events" of its "Methodology For Rating Sukuk" criteria. Specifically, the guidance clarifies how we assess total loss event (TLE) remoteness in our sukuk issue credit ratings. For the definition of the TLE, please see below, and for information on how it may affect the ratings on sukuk, please refer to the aforementioned criteria.

In assessing TLE remoteness, we typically use the specific definition of the TLE, the nature of the assets, as well as analytical judgement. If the TLE definition involves the physical destruction of the underlying assets, we would typically assess the risk as remote, depending on the geographical dispersion or concentration of the assets, geopolitical risks such as war, terrorism, or risk of conflict, and natural catastrophe risks, both in the jurisdiction(s) where the assets are located and within the timeframe of the transaction. If the TLE definition involves nonphysical loss, such as nationalization or confiscation risks, we would typically assess the risk as remote, unless we assess that the government demonstrates a tendency to nationalize that could directly or indirectly affect the sukuk's underlying assets within the timeframe of the transaction.

The table opposite includes guidance on how we assess TLE remoteness depending on the definition of the TLE and the nature of asset(s).

Key Publication Information

- Original publication date: May 2, 2019.
- Related to "Methodology For Rating Sukuk," published on Jan. 19, 2015.
- We may revise this guidance from time to time if regulatory developments and other factors outlined in the criteria warrant us re-evaluating some considerations regarding how we assess total loss event remoteness.

Analytical Contacts:

Mohamed Damak
Dubai
(971) 4-372-7153
mohamed.damak@spglobal.com

Samira Mensah
Johannesburg
(27) 11-214-4869
samira.mensah@spglobal.com

Sapna Jagtiani
Dubai
+ 97143727122
sapna.jagtiani@spglobal.com

Benjamin J Young
Dubai
(971) 4-372-7191
benjamin.young@spglobal.com

Methodology Contacts:

Erkan Erturk, PhD
New York
(1) 212-438-2450
erkan.erturk@spglobal.com

Lapo Guadagnuolo,
New York
(44) 20-7176-3507
lapo.guadagnuolo@spglobal.com

Assessment Of TLE Remoteness		
Asset/TLE definition	**Physical TLE**	**Nonphysical TLE**
Single asset	Generally remote, unless the asset is located in a war zone, an area at risk of conflict, or a zone subject to natural catastrophe risks that could affect the underlying asset within the timeframe of the transaction.	Generally remote, unless we assess that the government demonstrates a tendency to nationalize that could apply to the asset within the timeframe of the transaction.
Portfolio of assets in a single jurisdiction	Generally remote, unless the assets are located in a war zone, an area at risk of conflict, or a zone subject to natural catastrophe risks that could affect the underlying assets within the timeframe of the transaction.	Generally remote, unless we assess that the government demonstrates a tendency to nationalize that could apply to the assets within the timeframe of the transaction.
Portfolio of assets in multiple jurisdictions	Generally remote	Generally remote

TLE--Total loss event.

Physical TLE
We generally define a physical TLE as the destruction of, or damage to the whole of, the asset(s), or any event or occurrence that renders the whole of the asset(s) permanently unfit for any economic use, and the repair or remedial work in respect of the asset(s) is wholly uneconomical.

Nonphysical TLE
We generally define a nonphysical TLE as the expropriation, nationalization, requisition, confiscation, attachment, or sequestration of the asset(s).

Related Criteria

- Methodology For Rating Sukuk, Jan. 19, 2015

Related Research

- Criteria And Guidance: Understanding The Difference, Dec. 15, 2017

This report does not constitute a rating action.

This article is a guidance document for Criteria (Guidance Document). Guidance Documents are not Criteria, as they do not establish a methodological framework for determining Credit Ratings. Guidance Documents provide guidance on various matters, including: articulating how we may apply specific aspects of Criteria; describing variables or considerations related to Criteria that may change over time; providing additional information on non-fundamental factors that our analysts may consider in the application of Criteria; and/or providing additional guidance on the exercise of analytical judgment under our Criteria.

Our analysts consider Guidance Documents as they apply Criteria and exercise analytical judgment in the analysis and determination of Credit Ratings. However, in applying Criteria and the exercise of analytic judgment to a specific issuer or issue, analysts may determine that it is suitable to follow an approach that differs from one described in the Guidance Document. Where appropriate, the rating rationale will highlight that a different approach was taken.

MAF Sukuk Ltd.'s $600 Million Green Sukuk Rated 'BBB'

Primary Credit Analyst:

Sapna Jagtiani
Dubai
+ 97143727122
sapna.jagtiani
@spglobal.com

Secondary Contact:

Tommy J Trask
Dubai
(971) 4-372-7151
tommy.trask
@spglobal.com

Additional Contact:

Financial Institutions Ratings Europe
FIG_Europe
@spglobal.com

DUBAI (S&P Global Ratings) May 13, 2019--S&P Global Ratings today assigned its 'BBB' issue rating to the $600 million unsecured trust certificates issued by MAF Sukuk Ltd.

MAF Sukuk is a special-purpose vehicle (SPV) that is incorporated in the Cayman Islands, with one outstanding sukuk series under the program. It is affiliated with Dubai-based property firm Majid Al Futtaim Holding LLC (MAFH; BBB/Stable/A-2), which guarantees the company's transactions.

The rating on the trust certificates reflects the rating on MAFH because the transaction fulfills the five conditions of our criteria for rating sukuk (see "Methodology For Rating Sukuk," published Jan. 19, 2015, on RatingsDirect). The issuance is via a Wakala contract that comprises two components: a Murabaha contract (48.07%) and a sale-and-purchase agreement for real estate assets (51.93%).

The terms and conditions require a minimum of 34% of the sukuk proceeds be invested in a Wakala portfolio of assets, which include income-generating real estate assets or other Sharia-compliant tangible assets. A maximum of 66% of the proceeds can be used to purchase a commodity Murabaha investment to be sold to Majid Al Futtaim Properties (MAFP), MAFH's properties business unit, for a deferred sale price that includes the cost price of the commodities, a nominal profit, and, if applicable, any commodity tax.

Under the master trust deed, MAFH is required, among other obligations, to make up any shortfall between the exercise price, the deferred sale price, and the principal collections from the underlying assets in case of a dissolution event, at a sufficient price to repay the sukuk holders. This price is equivalent to the aggregate face value of the outstanding certificates, any accrued but unpaid periodic distributions, amounts repayable in respect of any liquidity facility, and any other amount payable by the trustee under the transaction documents.

Although the documentation mentions a risk of a total loss event (TLE), we view as remote the risk that a TLE will jeopardize the full and timely repayment of the sukuk. This is because any TLE would typically be mitigated by the guarantee provided by MAFH of full payment of principal and accrued unpaid profit after such an event. MAFH has an obligation to ensure that the assets are covered by insurance and to make up any shortfall between the insurance proceeds and principal amount, unless the company proves unequivocally that it has complied with its insurance obligations. Although such an exclusion might result in the residual exposure of investors to the underlying Wakala assets' risks, we consider the likelihood of a TLE occurring to be remote. Furthermore, we expect that MAFH's obligations to make up the value-restoration amount under the master trust deed will largely mitigate this risk.

We equalize our rating on the trust certificates with that on MAFH to incorporate our view that the instruments show limited structural subordination to MAFH's existing obligations. We expect the company will use the proceeds of the issuance for eligible green projects. In our view, the issuance will not cause MAFH's debt leverage ratios to deviate from our expectations for the issuer credit rating. To evaluate the certificates' structural subordination, we have applied our key credit factors for the real estate sector.

Related Criteria

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- Criteria | Corporates | Industrials: Key Credit Factors For The Real Estate Industry, Feb. 26, 2018
- General Criteria: Methodology And Assumptions: Assigning Equity Content To Hybrid Capital Instruments Issued By Corporate Entities And Other Issuers Not Subject To Prudential Regulation, Jan. 16, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- General Criteria: Methodology For Rating Sukuk, Jan. 19, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Leisure And Sports Industry, March 5, 2014 General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | Industrials: Key Credit Factors For The Retail And Restaurants Industry, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Criteria Clarification On Hybrid Capital Step-Ups, Call Options, And Replacement Provisions, Oct. 22, 2012
- Criteria | Financial Institutions | General: Methodology: Hybrid Capital Issue Features: Update On Dividend Stoppers, Look-Backs, And Pushers, Feb. 10, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria | Insurance | General: Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Related Research

- MAF Sukuk Ltd. Amended Sukuk Certificate Program's 'BBB' Rating Affirmed, Oct. 9, 2015

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

Presale:
STC Sukuk Co. Ltd.

Primary Credit Analyst:

Rawan Oueidat, CFA
Dubai
+ 971(0)43727196
rawan.oueidat@spglobal.com

Secondary Contacts:

Tommy J Trask
Dubai
(971) 4-372-7151
tommy.trask@spglobal.com

Mohamed Damak
Dubai
(971) 4-372-7153
mohamed.damak@spglobal.com

Additional Contact:

Industrial Ratings Europe
Corporate_Admin_London@spglobal.com

This presale report is based on information as of April 24, 2019. This report does not constitute a recommendation to buy, hold, or sell securities. Ratings will depend upon receipt and satisfactory review of all final transaction documentation, including legal opinions. Accordingly, the ratings should not be construed as evidence of final ratings. If S&P Global Ratings' does not receive final documentation within a reasonable time frame, or if final documentation departs from materials reviewed, S&P Global Ratings reserves the right to withdraw or revise its ratings.

Profile

Proposed US$5 billion sukuk trust certificates program: assigned preliminary 'A-' rating.

Transaction Overview

This presale report is based on information dated April 24, 2019, and is posted in conjunction with the planned U.S. dollar-denominated $5 billion sukuk program by STC Sukuk Co. Ltd. (STC Sukuk), a special purpose vehicle (SPV) incorporated with limited liability in the Cayman Islands.

Under the sukuk documents, STC Sukuk will enter, among other contracts, into a combination of a restricted mudaraba agreement for 51% of the sukuk proceeds and a murabaha agreement for 49% of the sukuk proceeds, with Saudi-based telecom operator Saudi Telecom Co. (STC; A-/Stable/A-2). Under the restricted mudaraba, STC, as mudareb, will acquire certain predefined assets, which will be subsequently leased to STC, in its capacity as lessee, under a lease agreement between STC (as lessee), STC (as lessor and mudareb), and the delegate and the SPV (STC Sukuk). We understand that the sukuk proceeds will be used to fund general corporate needs.

Rationale

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

- STC will enter contractual obligations sufficient for the payment of the principal and the periodic distribution amounts. The payment of the periodic distributions will be covered by the periodic rental under the lease agreement, which will match the periodic distribution rate on the sukuk plus an additional amount to cover the management fee of the mudareb (under the mudaraba agreement 99% of the revenues go to the SPV and 1% to the mudareb). The payment of the principal will be covered by the combination of the payment of the murabaha deferred sale price (49% of the principal consisting of the commodities purchase price and 36% consisting of the profit element) and the initial rental under the lease agreement consisting of 15.15% of the principal.

- STC's obligations under the murabaha and lease contracts are irrevocable.

- These obligations will rank pari passu with STC's other senior unsecured financial obligations.

- STC will undertake to cover all the costs related to the transaction, through the additional supplementary rent under the leasing and the service agency agreements.

- Although the documentation includes a total loss event (TLE), we view as remote that such event would occur and jeopardize the full and timely repayment of the sukuk. Our opinion is underpinned by our understanding that the portfolio of underlying assets is geographically diversified telecommunication cable and equipment assets located across Saudi Arabia. S&P Global Ratings will assess the probability of TLE for each drawdown separately, based on the geographic composition of the portfolio of underlying assets, and this might result in a different rating if we assess the TLE event as non-remote.

- We view the presence of the restricted mudaraba as neutral from a risk perspective. The mudaraba income is calculated based on the constructive liquidation of the mudaraba assets and the rental income.

We therefore equalize the rating on the sukuk with the long-term issuer credit rating on STC. The rating on the sukuk transaction is based on draft documentation dated April 24, 2019. Should final documentation differ substantially from the draft version, we could change the rating on the sukuk.

Our rating is based on certain assumptions, such as the 36% profit rate for the murabaha contract, therefore ensuring 100% principle protection from both murabaha and mudarabah agreements. S&P Global Ratings will assess each drawdown separately to confirm its assumptions. If these do not hold, we might assign a different rating or might not rate the drawdown.

STC Sukuk Co. Ltd. Transaction Details

Lessee, Mudareb, Purchaser, Service agent	Saudi Telecom Co.
Issuer, Trustee, Rab al Maal	STC Sukuk Co. Ltd.
Arrangers	HSBC Bank PLC, J.P. Morgan Securities PLC, and Standard Chartered Bank.
Delegate	HSBC Corporate Trustee Co. (UK) Ltd.
Principal paying agent, paying agent, and exchange agent	HSBC Bank PLC
Governing law	English law

A sukuk structure that provides sufficient contractual obligations for full and timely payment of coupon and principal

The transaction involves an SPV incorporated in the Cayman Islands, STC Sukuk, issuing rated sukuk trust certificates.

Under the sukuk documents, the SPV will enter, among other contracts, into a combination of:

- A restricted mudaraba agreement for 51% of the sukuk proceeds. Under this mudaraba, STC as mudareb, will acquire certain predefined assets. These assets will be subsequently leased to STC in its capacity as lessee, under a lease agreement between STC (as lessee), STC (as lessor and mudareb) and the delegate and the SPV; and

- A murabaha agreement for 49% of the sukuk proceeds, with STC as buyer.

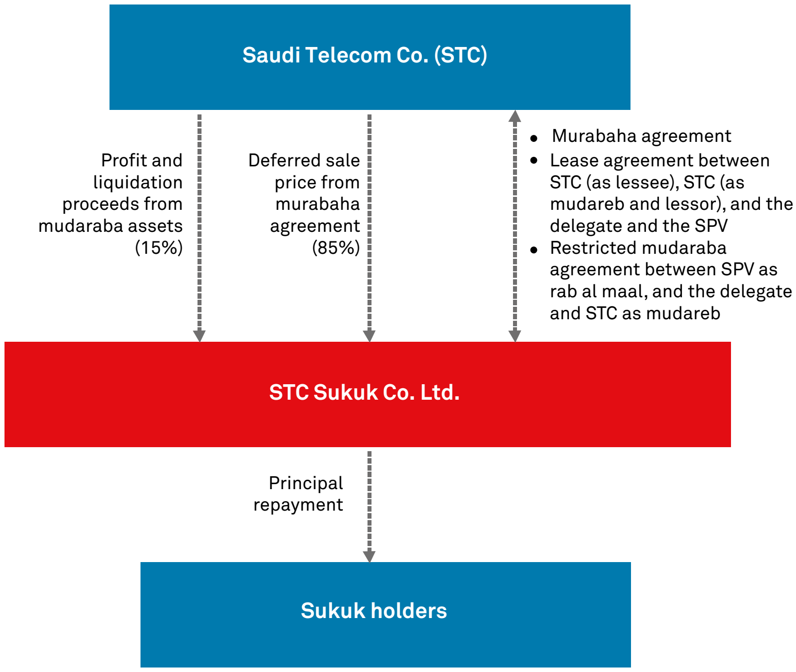
Under the lease agreement, STC will pay periodic rentals, the amount of which is calibrated to match the periodic distribution amounts payable to the sukuk holders on a timely basis. This profit rate will match the periodic distribution rate on the sukuk, plus an amount to cover the management fee of the mudareb (because under the mudaraba agreement 99% of the revenues go to the SPV and 1% to the mudareb). STC's obligations under the lease agreement are irrevocable and unconditional, and will rank equally with STC's other senior unsecured financial obligations.

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

- STC will pay the murabaha deferred sale price (49% of the principal consisting of the commodities purchase price and 36% consisting of the profit element);
- STC will proceed with the constructive liquidation of the restricted mudaraba, which will include among others the initial rent, payable under the lease agreement consisting of 15.15% of the principal. STC's obligations under the lease and the murabaha agreements are irrevocable and unconditional, and will rank equally with STC's other senior unsecured financial obligations.

If a dissolution event occurs, the trustee (the issuer) or the delegate is expected to deliver a notice to STC declaring that the principal payment amount is immediately due and payable. Should this not occur in a timely fashion and the principal payment is delayed, we may lower the rating on the sukuk to 'D' (see paragraph 11 of the sukuk criteria) if this payment does not occur in a timely manner as we define it (see paragraph 12 of the sukuk criteria).

Chart 1 - STC Sukuk Co. Ltd - Principal Repayment (Simplified Schematic)



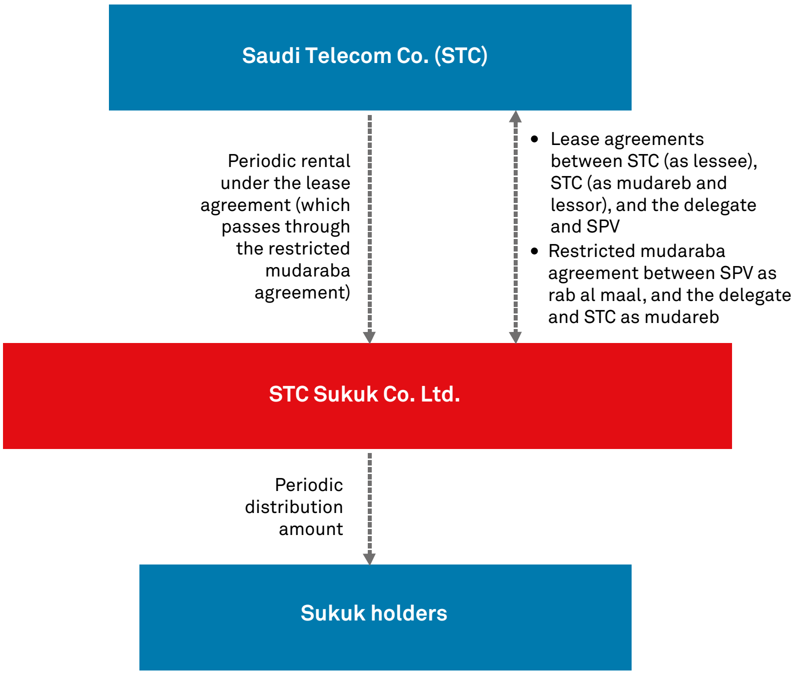
Source: Saudi Telecom Co. and S&P Global Ratings.

Total Loss Event

While the documentation includes a TLE, we view as remote the risk that a TLE would occur and jeopardize the full and timely repayment of the sukuk. The service agent has the obligation to ensure that the assets are covered by insurance and also to make up any shortfall between insurance proceeds and the principal amount, unless it proves beyond any doubt that it has complied with its insurance obligations and was not negligent. Although this exclusion might result in a residual exposure for investors to the underlying leasing assets' risks, we base our rating on the assumption that a TLE is remote, which is predicated on our expectations that the portfolio of the underlying assets will be geographically diversified. This assumption will be tested at each drawdown and in case of a change in the structure of the portfolio of underlying assets during the lifetime of a specific drawdown. S&P Global Ratings will assess the probability of a TLE for each drawdown separately, based on the geographic composition of the portfolio of underlying assets, and this might result in a different rating if we assess the TLE event as non-remote.

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

Chart 2 - STC Sukuk Co. Ltd - Periodic Distributions Payment (Simplified Schematic)



Source: Saudi Telecom Co. and S&P Global Ratings.

Related Criteria

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- General Criteria: Methodology For Rating Sukuk, Jan. 19, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Telecommunications And Cable Industry, June 22, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Presale:
SD International Sukuk Ltd.

Primary Credit Analyst:

Vishal Kulkarni, CFA
Singapore
(65) 6216-1047
vishal.kulkarni@spglobal.com

Secondary Contact:

Bertrand P Jabouley, CFA
Singapore
(65) 6239-6303
bertrand.jabouley@spglobal.com

This presale report is based on information as of April 15, 2019. This report does not constitute a recommendation to buy, hold, or sell securities. Final ratings will depend upon receipt and satisfactory review of all final transaction documentation, including legal opinions. Accordingly, this presale report should not be construed as evidence of final ratings. If S&P Global Ratings does not receive final documentation within a reasonable time frame, or if final documentation departs from materials reviewed, S&P Global Ratings reserves the right to withdraw or revise its ratings.

Profile

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

Transaction Overview

This presale report is based on information dated April 15, 2019, and is posted in conjunction with the planned issuance of U.S. dollar-denominated sukuk (trust certificates) by SD International Sukuk Limited incorporated in Labuan, Malaysia.

- SD International Sukuk Ltd. (issuer, trustee) will enter into a "Commodity Murabaha Investment Agreement" (Murabaha agreement, for at most 49% of sukuk issuance amount) with Serba Dinamik International Ltd. (SDIL, obligor and wakeel). The deferred payment price, agreed under the Commodity Murabaha Investment agreement, comprises the aggregate of the principal amount and the profit agreed under the same agreement. Murabaha profit is distributed in equal installments that match the periodic distribution amount and dates.

- Issuer will enter into Wakala agreement (for at least 51% of sukuk issuance amount) with SDIL, wholly owned subsidiary of Serba Dinamik Holdings Bhd. (SDHB), an engineering and construction company, based in Malaysia. We understand that this contract is used to ensure the Sharia compliance of the transaction and that it will be completely separate from the Murabaha contract. That means that the cash flow of the Murabaha contract cannot be used, and the sponsor will compensate for a potential loss on the Wakala contract.

- SDHB (parent and guarantor) guarantees the obligations of SDIL through a Deed of Guarantee. The obligations under this guarantee deed will rank equally with all the senior unsecured obligations of SDHB. Moreover, SDIL through the declaration of trust undertakes to cover all the costs related to the transaction.

Rationale

The preliminary issue rating reflects the guarantee by SDHB (BB-/Stable/--), the long-term preliminary issuer rating on guarantor, and the fact that the transaction fulfils the five conditions of our criteria for rating sukuk (see "General Criteria: Methodology For Rating Sukuk," published Jan. 19, 2015, on RatingsDirect):

- SDIL will provide sufficient, irrevocable, and timely contractual obligations for the payments of the periodic distribution amounts payable on the periodic distribution dates and the repayment of principal amount through deferred payment price agreed under the Commodity Murabaha agreement. The deferred payment price comprises the aggregate of the principal amount and the profit agreed under the same agreement. Murabaha profit is distributed in equal installments that match the Periodic Distribution amount and dates. The proceeds from Wakala and Murabaha legs of the transaction will be collected separately such that losses from Wakala does not affect proceeds and distribution under Murabaha. The obligations of SDIL are guaranteed by SDHB.

- SDIL's obligations are irrevocable and unconditional.

- The guarantee provided by SDHB on SDIL's obligations will rank equally with SDHB's other senior unsecured financial obligations.

- SDIL will undertake to cover all the costs related to the transaction for the benefit of SD International Sukuk Ltd. Such cost reimbursements are covered under Wakala, Murabaha agreements and under the declaration of trust agreement. SDIL's obligations are guaranteed by SDHB.

- The documentation does not mention a risk of total loss event. A total loss event is not a major risk as under the structure there is no physical asset involved.

We equalize the issue rating on the U.S. dollar-denominated sukuk to the issuer credit rating on SDHB because we project the proportion of secure debt at SDHB to be less than 50% of total consolidated debt over the next two years at least. Moreover, all the debt in SDHB's capital structure will sit at the parent SDHB. SDHB guarantees SDIL's obligation toward the sukuk.

SD International Sukuk Ltd. -- Transaction Details

Issuer, trustee, seller of commodities	**SD International Sukuk Ltd., incorporated in Labuan, Malaysia.**
Obligor Wakeel, and buyer of the commodities	Serba Dinamik International Ltd.
Periodic distribution	Murabaha profit paid semiannually on the day prior to periodic distribution date under Commodity Murabaha Investment Agreement.
Dissolution distribution amount	Deferred payment price paid by SDIL that is at least equal to sukuk issuance amount.
Lead manager, Principal paying agent, registrar and transfer agent	The Hong Kong and Shanghai Banking Corp. Ltd.
Governing law	English law

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

The transaction involves SD International Sukuk Ltd., a special-purpose company incorporated in Labuan, Malaysia, for issuing trust certificates. The issuer will use the proceeds of the sukuk to acquire beneficial interest in a pool of underlying assets, including Wakala assets (for at least 51% of the sukuk proceeds) and Murabaha assets made of commodities (for 49% maximum of the sukuk proceeds). The issuer undertakes to use the proceeds of the sukuk to enter into a Wakala agreement, in which the wakeel will invest in the Shariah compliant business of the obligor.

Both the periodic distribution amount and dissolution distribution amounts will be paid by the Murabaha leg of the transaction. Each periodic distribution will be paid as follows:

- The deferred payment price comprises the aggregate of the principal amount and the profit agreed under the Commodity Murabaha agreement.

- Such deferred payments (primarily Murabaha profit component) will be paid by the buyer of the commodity (SDIL) to seller of the commodity (issuer) prior to periodic distribution.

At the maturity date of the transaction or upon the occurrence of an early dissolution event, SDIL (buyer of commodities) will immediately do the following:

- Under the Murabaha agreement, pay issuer agreed deferred payment price that would be equivalent to the original value of the sukuk principal; Wakeel (SDIL, the obligor) will liquidate all the Wakala assets at market price and credit those sale proceeds to the issuer's account.

- Credit the proceeds from Murabaha and Wakala agreements in separate account such that potential losses (if any) in the Wakala leg of transaction do not affect cash flows from the Murabaha leg of transaction accruing to issuer.

- Both the periodic distributions and dissolution amount will be paid by the Murabaha leg of the transaction. Both the periodic distributions and dissolution amount payment thus form part of SDIL's obligations. If SDIL fails to pay, SDHB as a guarantor will step in.

- The execution of the Murabaha contract, and the guarantee, will allow the issuer to receive the deferred sales payment equal to the sum of its periodic distribution and dissolution amount obligations that will be used to pay back the investors at the scheduled maturity or upon the occurrence of a dissolution event (see chart 2). The Wakala contract ensures the Sharia compliance of the transaction.

These financial obligations of SDIL and SDHB are unconditional and will rank equally with their other senior unsecured obligations.

Chart 1 - Brief Overview of The Sukuk Agreements

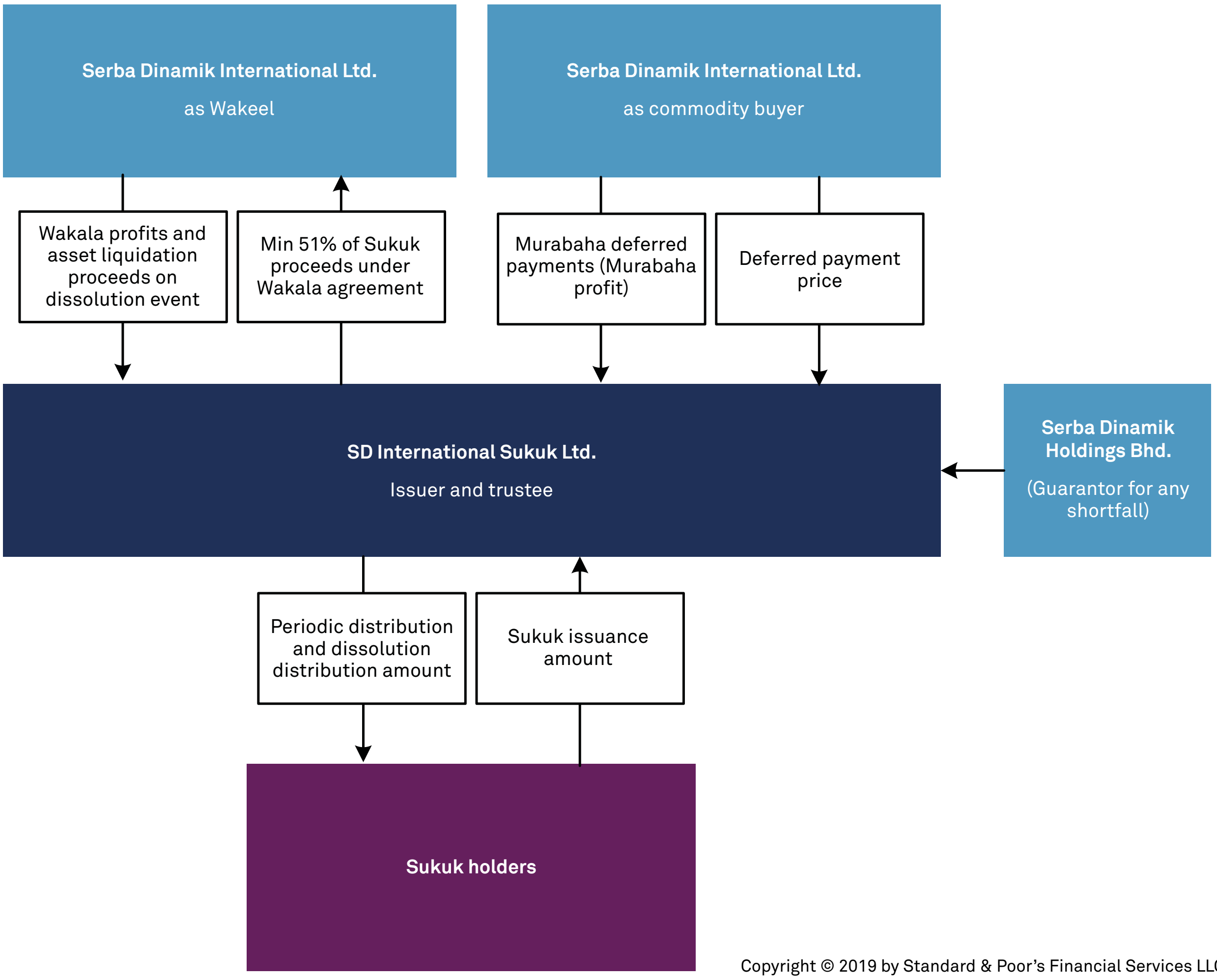
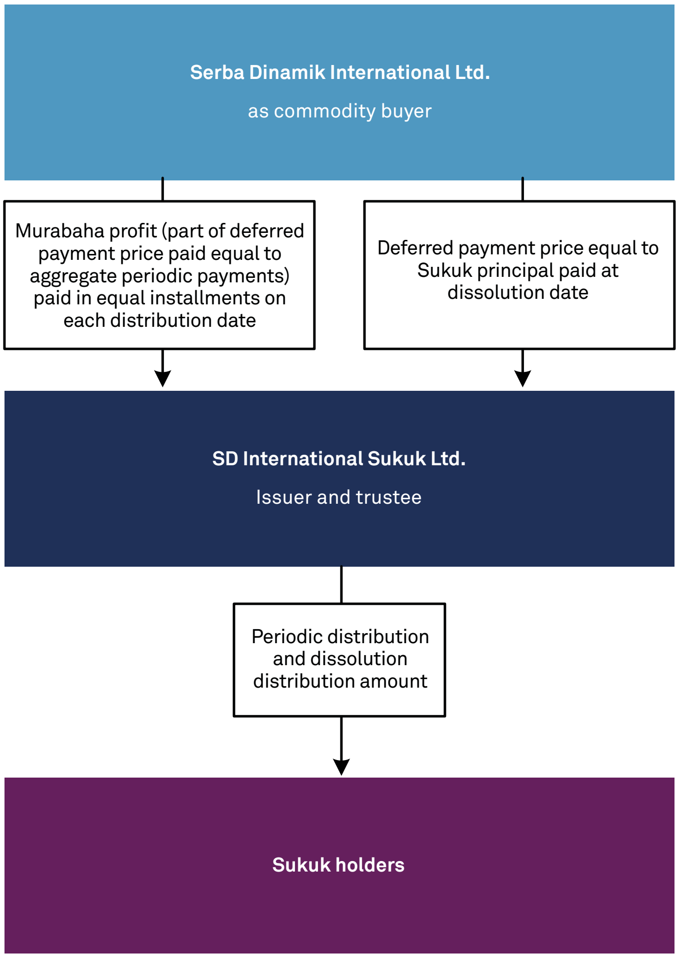


Chart 2 - Sukuk Periodic Distribution And Principal Payment



All of SDIL's obligations under the Murabaha and Wakala agreement are irrevocable, unsubordinated and will rank equally with all SDIL's and SDHB's other unsubordinated financial obligations. SDIL will also cover all the costs related to the transaction through cost reimbursement clauses in the Murabaha, Wakala, and Declaration of Trust agreements for the benefit of SD International Sukuk Ltd.

Total Loss Event

The risks for a total loss event are not mentioned as part of the legal documents of the transaction and therefore cannot disrupt the payments. A total loss event is not a major risk as under the structure there is no physical asset involved.

Issue Ratings--Subordination Risk Analysis

Capital structure

SDHB's capital structure will consist of U.S. dollar-denominated senior unsecured sukuk and MYR500 million of Islamic notes issued under its medium-term notes program.

Analytical conclusions

We equalize the issue rating on the U.S. dollar-denominated sukuk to the issuer credit rating on SDHB because we project the proportion of secure debt at SDHB to be less than 50% of total consolidated debt over the next two years at least.

This report does not constitute a recommendation to buy, hold, or sell the trust certificates. S&P Global Ratings neither structures sukuk transactions nor provides opinions about the compliance of the transaction with Sharia.

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- Criteria | Corporates | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016 General Criteria: Methodology For Rating Sukuk, Jan. 19, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | Industrials: Key Credit Factors For The Engineering And Construction Industry, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012

Related Research

- SD International Sukuk Ltd.'s Proposed Sukuk Trust Certificates Assigned Preliminary 'BB-' Rating, April 24, 2019

Presale:

Presale: Almarai Sukuk Ltd.

Primary Credit Analyst:
Maxime Puget
Paris
(33) 1-4075-2577
maxime.puget
@spglobal.com

Secondary Contact:
Sapna Jagtiani
Dubai
+ 97143727122
sapna.jagtiani
@spglobal.com

Additional Contact:
Industrial Ratings Europe
Corporate_Admin_
London@spglobal.
com

This presale report is based on information as of Feb. 19, 2019. This report does not constitute a recommendation to buy, hold, or sell securities.

Profile

US$2 billion sukuk trust certificate program assigned 'BBB-' rating.

Transaction Overview

This presale report is based on information dated Feb. 19, 2019, and is posted in conjunction with the U.S. $2 billion sukuk program, to be issued by Almarai Sukuk Ltd., a special-purpose vehicle incorporated with limited liability in the Cayman Islands.

Under the sukuk documents, Almarai Sukuk will enter, among other contracts, into a sale, purchase undertaking and Murabaha agreements with Saudi-based food and beverages manufacturer Almarai Company (BBB-/Stable/A-3). We understand that the proceeds will be used to repay existing debt and fund general corporate needs.

The sukuk program will comprise a combination of Murabaha (up to 66% of tranche value) and Ijara agreements (at least 34% of tranche value). The underlying assets under the Ijara agreement will be dairy farm plants, owned by Almarai Company, located in Riyadh, Saudi Arabia.

Rationale

The rating on the sukuk program reflects the issuer credit rating on Almarai Company, because the transaction fulfills our five conditions for rating sukuk (see "Methodology For Rating Sukuk," published Jan. 19, 2015, on RatingsDirect):

- Almarai Company will provide sufficient contractual obligations for the payment of the periodic distribution amounts (via the leasing and Murabaha agreements) and the principal amount via the purchase undertaking and the Murabaha agreement;

- Almarai Company's obligations under the sukuk terms and conditions are irrevocable. These obligations will rank pari passu with Almarai Company's other senior unsecured financial obligations.

- Almarai Company will undertake to cover all the costs related to the transaction, through the supplementary rent under the leasing agreement and the master trust deed.

- 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 dairy farm assets located in Saudi Arabia. S&P Global Ratings will assess the probability of TLE for each drawdown separately based on the composition of the portfolio of underlying assets and this might result in a different rating if we assess the TLE event as non-remote.

We therefore equalize the rating on the sukuk program with the long-term issuer credit rating on Almarai Company. The rating on the sukuk transaction is based on final documentation dated Feb. 19, 2019.

Almarai Sukuk Ltd. Transaction Details	
Issuer, Trustee	Almarai Sukuk Ltd., incorporated in Cayman Islands
Seller of the assets	Almarai Company
Servicing agend, buyer, and sellers of the underlying assets	Almarai Company
Global coordinators and arrangers	First Abu Dhabi Bank, HSBC
Principal pauing agent, delegate	HSBC Corporate Trustee Company (UK) Limited
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 the Cayman Islands, Almarai Sukuk Ltd., issuing rated sukuk trust certificates.

We understand that the issuer, Almarai Sukuk Ltd., will use the proceeds of the sukuk as follows:

- No more than 66% of the sukuk proceeds to acquire a portfolio of commodities (Murabaha assets); and

- Not less than 34% of the sukuk proceeds to be held in Ijara portfolio (lease financing).

Under the leasing agreement, Almarai Sukuk Ltd. will lease the assets (notably dairy farm plants in Saudi Arabia) to Almarai Company in return for periodic rental payments. In addition, the profit element of the Murabaha agreement will be paid at regular intervals coinciding with the periodic distribution dates. We understand that these two amounts were calibrated to match the periodic distribution amounts payable to the sukuk holders on a timely basis. Almarai Company's obligations under the lease and Murabaha agreements are irrevocable, unconditional and will rank equally with Almarai Company's other senior unsecured financial obligations.

At the maturity date of the transaction, Almarai Company will pay the exercise price under the purchase undertaking. This price includes, among others, the face amount of the sukuk, all accrued but unpaid periodic distribution amounts if any, and any expenses payable by the special purpose vehicle under the transaction documents, less the aggregate amount of the deferred sale price, which will be paid under the Murabaha agreement (all of them we define as the principal payment amount). Almarai Company's obligations, under the purchase undertaking and the Murabaha agreement are irrevocable, unconditional and will rank equally with Almarai Company's other senior unsecured financial obligations.

If an early dissolution event occurs, while the trustee (the issuer) or the delegate is expected to deliver an exercise notice to Almarai Company declaring that the principal payment amount is immediately due and payable, this payment will occur only on the Dissolution Event Redemption date. The ratings on Almarai Company and the sukuk could come under extreme pressure (see paragraph 11 of our sukuk criteria) should this payment occur in a non-timely manner, as per our definition of timeliness (see paragraph 12 of our sukuk criteria).

Total Loss Event

While the documentation mentions TLE risk, we think there is only a remote possibility that a TLE would jeopardize the full and timely repayment of the sukuk. The servicing agent has the obligation to ensure that the assets are covered by insurance and to compensate for any shortfall between insurance proceeds and the principal amount, unless it proves beyond any doubt that it has complied with its insurance obligations and was not negligent. Although this exclusion might result in a residual exposure of investors to the underlying leasing assets' risks, we base our rating on the assumption that TLE is remote, which is predicated on our expectations that the portfolio of the underlying assets will be diversified. This assumption will be tested at each drawdown and in the event of a change in the structure of the portfolio of underlying assets during the lifetime of a specific drawdown. We will assess the probability of TLE for each drawdown separately based on the composition of the portfolio of underlying assets, and this might result in a different rating if we assess the TLE event as non-remote.

The rating on the sukuk transaction is based on final documentation. This report does not constitute a recommendation to buy, hold, or sell the trust certificates, S&P Global Ratings neither structures sukuk transactions nor provides opinions with regards to compliance of the transaction with Sharia.

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- Criteria - Corporates - Industrials: Key Credit Factors For The Branded Nondurables Industry, May 7, 2015 General Criteria: Methodology For Rating Sukuk, Jan. 19, 2015
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Almarai Sukuk Ltd. $2 Billion Sukuk Trust Certificate Program Assigned 'BBB-' Rating, Feb. 19, 2019
- Saudi Food And Beverages Group Almarai Rated 'BBB-/A-3'; Outlook Stable, Feb. 14, 2019

Islamic Finance And ESG: The Missing 'S'

Primary Credit Analyst:

Mohamed Damak
Dubai
(971) 4-372-7153
mohamed.damak
@spglobal.com

Secondary Contacts:

Dhruv Roy
Dubai
(44) 20-7176-6709
dhruv.roy
@spglobal.com

Corinne B Bendersky
London
+ 44 20 7176 0216;
corinne.bendersky
@spglobal.com

Noemie De La Gorce
London
+ 44 20 7176 9836;
Noemie.delagorce
@spglobal.com

Additional Contact:

Financial Institutions Ratings Europe
FIG_Europe
@spglobal.com

S&P Global Ratings recognizes that environmental, social, and governance (ESG) factors have rapidly increased their prominence in global credit markets. Issuers are increasingly improving transparency on the potential effects of disruption from climate risk and other perils, as well as human and natural resources management, and sensitivities to demographic changes and technological advancements, among other factors.

In our view, Islamic finance, which must abide by the goals or objectives (Maqasid) of Sharia, shares some links with ESG considerations and the broader aim of sustainable finance. As regulators and policymakers around the world seek to establish a more sustainable, stakeholder-focused, and socially responsible financial system in the future, we see some complementarities between Islamic finance and sustainable finance.

Key Takeaways

- We see some similarities between the principles of Sharia and environmental, social, and governance factors.
- The 'E' and the 'G' are more visible, owing to the presence of green sukuk and an additional layer of governance in Islamic finance.
- The 'S' factor has historically been less visible, but the industry is slowly moving into this direction.

Possible Parallels Between Islamic Finance Principles And Sustainable Finance

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, money 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 prohibited under Sharia: notably alcohol and brewing, tobacco, weapons and armaments, or pork-based products. Reportedly, the ultimate goal of these principles is to create a sustainable, stakeholder-focused, and socially responsible financial system. More broadly, Islamic finance has to abide by the goals or objectives (Maqasid) of Sharia. There are several definitions or interpretations of the goals of Sharia but they broadly evolve around the protection of faith, life, mind, wealth, and dignity.

Sustainable finance, on the other hand, focuses on driving players throughout the financial system to integrate ESG objectives into their activities and capital allocation. For an entity, it involves a focus on improving its own performance across ESG factors. From an investor standpoint, it includes a number of investing approaches, such as screening assets based on environmental, social, or ethical criteria, the integration of ESG factors in investment decision-making, and investment based on social impact, among others. Sustainable finance also involves the bond market, with the issuance of green, social, and sustainability bonds, where proceeds are restricted for assets with environmental or social purposes, or a combination of the two.

In this context, we consider that there may be parallels between the objectives of sustainable finance and some of the underlying principles of Sharia. For example, the Islamic finance protection of life goal aligns with sustainable finance principles, which emphasize environmental and social protection including either refraining from developing or financing operations that could adversely impact the environment and/or the health or the well-being of humankind. There are also parallels between the social focus of ESG analysis and integration and the principle of profit- and loss-sharing, both of which ultimately aim to adopt a stakeholder view and increase social cohesion, and ensure that no one is left behind. On the governance side, Islamic banks and instruments are typically subject to an additional layer of governance compared with their conventional counterparts. Islamic banks and products are typically approved by Sharia boards, which ensure the conformity of these products with Sharia at any point in time during their life cycle. Finally, tracking the allocation of proceeds to eligible projects is a principle that we also observe for ESG-linked issuance. The Sharia requirement that tangible and identifiable assets must back transactions aligns with the substantial green and social infrastructure development needed to support the transition to a low carbon economy.

Nevertheless, the consideration of ESG factors for a company or an investment product doesn't necessarily confer conformity with Sharia. A company that produces goods or services that would be considered non-Sharia compliant may comply with ESG considerations and vice versa.

The 'E' And 'G' Are More Visible

The 'E' and 'G' factors seem to us to be more visible in Islamic finance than the 'S'. A green sukuk, for example, is a form of Islamic financial instrument in which issuers use the proceeds to finance investments in renewable energy or other environmental assets, such as solar parks, biogas plants, wind energy projects, as well as renewable transmission and infrastructure projects. To date, several green sukuk have been issued, primarily in Southeast Asian countries and the Gulf, with the latest being the $600 million green sukuk issued by Majid Al Futtaim (a diversified group based in the United Arab Emirates) in May 2019. The amount is still minimal compared with the global green bond market that saw $168 billion of issuances in 2018, but it is growing. Green sukuk have reportedly allowed issuers to access not only the pool of conventional investors interested in green projects, but also Islamic investors. This could lead to potential excess demand and better financing conditions.

Given the rapid increase in energy demand and the objective of shifting energy provision to greener sources in some core Islamic finance countries (particularly Malaysia, the United Arab Emirates, and Saudi Arabia), the opportunities for green sukuk appear significant. Beyond green sukuk, we consider that the rising interest in and growth of ESG-related assets under management, will encourage Islamic finance to progressively shift from a negative screening of projects and operations to a positive screening, where projects with a positive ESG impact are given priority because of the links between ESG objectives and Islamic finance. This process has already started: some leading Islamic banks have allocated a part of their business to responsible financing. Bahrain-based Al Baraka Banking Group, for example, has set a specific goal for the use of green energy in some of the bank's subsidiaries.

With regards to the 'G' factor, Islamic banks and sukuk are subject to an additional layer of governance compared with their conventional counterparts. Islamic banks and products need to have a Sharia board, which consists typically of three Sharia scholars having the responsibility of issuing Fatwas (or opinion of conformity with Sharia). They are also subject to internal Sharia audit, and the industry is slowly leaning toward external Sharia audit. The Sharia board reports its findings to the boards of directors of the institution and the different stakeholders. While this layer of governance should provide additional oversight, it did not prevent the industry from going through some episodes of instability, such as the recent instance in which an issuer did not pay back investors on the basis that its sukuk was, reportedly, no longer compliant with Sharia. In order to push the governance aspect forward, we believe the industry needs inclusive standardization of Sharia interpretation and legal documentation and awareness of ESG factors. The process would combine issuers, investors, regulators, and Sharia scholars' perspectives to help the market shape its future direction. In our view, inclusive standardization is not only achievable, it will also boost the industry and the volume of issuance. Ultimately, it will restore the attractiveness of the instrument to issuers through a smoother, faster issuance process and increased clarity on the underlying risks for investors.

The Missing 'S'

The social aspect appears to have been cast somewhat to the back seat. While the underlying principles are socially focused and a number of instruments already exist, they have not been leveraged in modern Islamic finance in a transparent, systematic manner. This may be because Islamic banks, as issuers themselves, do not appear to focus on their own social performance. At present, there are limited public disclosures on how Islamic banks or issuers of sukuk are dealing with social issues (such as workforce and diversity, safety management, customer management, and communities). However, we understand that they are not dealing with these issues in a significantly different manner from conventional banks in their respective countries or systems. From the perspective of financing activities, the lack of visibility of the 'S' factor is underpinned by the fact that Islamic banks are, at the end of the day, commercial entities that seek financial performance among other factors and it is not because of a lack of instruments or products. In fact, socially responsible products do exist in Islamic finance and their size is reportedly substantial. Three instruments are worth mentioning:

- 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.

- 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.

These products could make a difference when it comes to socially responsible financing. At the same time, we think it will require a proper governance framework for their use in order to reach this objective. As the amounts are high, users can be tempted to divert these instruments from their original purpose. For example, investing Waqf cash in Sukuk and using the return for Waqf purposes might be perceived as diverting Waqf money from its original purpose. Similarly, using Waqf money to fulfill certain objectives other than social ones might not be an acceptable approach for Islamic finance stakeholders. As we understand it, the intention of Waqf money is rather to achieve social objectives, such as improving people's living standards by providing basic services, affordable education, health care, or housing. Blending Waqf money with private sector money could also have a bigger impact. However, that assumes a strong layer of governance and protection of the Waqf money, and simply avoiding that it would act as a first-loss tranche to protect private sector investors from taking their fair share of risk.

To be fair to them, a few Islamic banks have set public objectives on social responsibility. Al Baraka Banking Group, for example, announced that it aims to contribute to the creation of 51,000 jobs, and finance $191 million education projects and $434 million health care projects by 2020. In Malaysia, the Central Bank in 2018 issued a framework for value-based intermediation (VBI) aimed ultimately at delivering the intended outcomes of Sharia through practices, conduct, and offerings that generate a positive and sustainable impact to the economy, community, and environment, and that are consistent with the shareholders' sustainable returns and long-term interests.

Therefore, in our opinion, the Islamic finance industry is slowly realizing that it could contribute to a sustainable financial system. We think that the contribution will remain limited, though, at least in the short term. We estimate the size of the global Islamic finance industry at around $2.1 trillion at year-end 2018. While there are no estimates on the total size of the Waqf assets and Zakat flows, it is reportedly substantial.

ESG And Ratings In Islamic Finance

We incorporate ESG considerations into our ratings methodology and analytics of Islamic financial institutions and sukuk in a similar way as we do for conventional issuers and issues (see "Related Research" below). For sukuk ratings, the ESG considerations would generally be reflected in the sponsor rating. For sovereign sukuk, for example, institutional quality and governance effectiveness is a key factor for the rating on the sovereign sponsor. Indeed, it accounts for approximately one-quarter of the indicative sovereign rating. Similarly, for banks, we take into consideration deficiencies in the overall quality of a banking system's governance and transparency in our Banking Industry Country Risk Assessment, which is the starting point for assigning a bank rating. The impact could also be reflected in the individual assessment of a bank through our assessment of the quality of its management and strategy, or through its potential exposure to losses on its financing or investment portfolios because of ESG-related considerations (such as climate change). Finally, for Takaful companies, risks inherent to the insurance markets in which the company operates or specific risks undertaken by the insurance company (such as exposure to climate change) are factored into our macro assessment of the insurance company.

Related Research

- S&P Global Ratings Launches Its ESG Evaluation, April 11, 2019
- The ESG Advantage: Exploring Links To Corporate Financial Performance, April 8, 2019
- The Rise Of ESG In Fixed Income, Sept. 10, 2018

This report does not constitute a rating action.

GCC Islamic Banks Will Likely Stay Resilient In 2019-2020

Primary Credit Analyst:
Mohamed Damak
Dubai
(971) 4-372-7153
mohamed.damak@spglobal.com

Secondary Contact:
Suha Urgan
Dubai
(971) 4-372-7175
suha.urgan@spglobal.com

Additional Contact:
Financial Institutions Ratings Europe
FIG_Europe@spglobal.com

Like their conventional peers, Islamic banks in Gulf Cooperation Council (GCC) countries have seen growth slow in recent years. Some banks' exposure to Turkey has exacerbated the situation, after the country experienced significant volatility in 2018, and this remains a major source of risk, in our view.

However, despite this and challenges at home, several GCC Islamic banks maintained sound asset-quality and profitability indicators. In addition, their funding profiles remain healthy, dominated by core customer deposits, and capitalization is still a major positive rating factor.

Key Takeaways

- S&P Global Ratings believes GCC Islamic banks' total assets will increase by mid-single digits over the next 12-24 months.
- Despite the significant changes in the local and external operating environments and new accounting standards, Islamic banks' financial profiles remain broadly stable.
- We believe only a major increase in geopolitical risk or a significant drop in oil prices could weaken the credit profile of the industry.

Islamic Banks Lost Ground in 2018

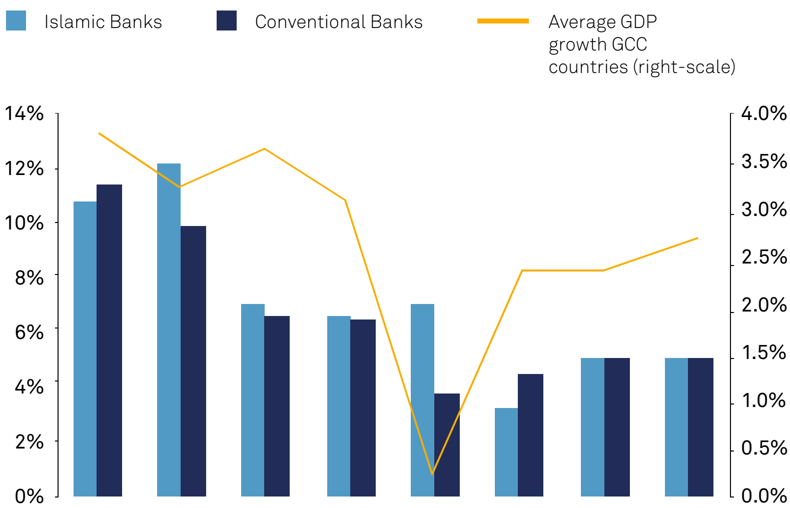
In 2018, GCC Islamic banks expanded slower than conventional peers for the first time in five years. We attribute this to three main reasons:

- Some of the Islamic banks we analyzed were hit by currency depreciation (particularly of the Turkish lira), which reduced their asset base in U.S. dollar terms.
- Certain banks in the United Arab Emirates (UAE) recorded strong growth, but they represent only a small proportion of our Islamic banks sample, compared with the conventional one.
- Islamic banks in Qatar displayed a negative growth rate for 2018 due to consolidation and the slowdown of some economic sectors in the country.

However, the growth difference was a mere 1%, which explains why we think the conventional and Islamic banks in our sample will see similar growth patterns in 2019-2020. We project mid-single-digit growth for both types of banks due to several factors. These include our forecast of muted GCC economic growth over this period, despite some benefit from government spending and strategic initiatives such as national transformation plans, the 2022 FIFA World Cup, and Dubai Expo 2020. We also assume that oil prices will average $60 per barrel (/bbl) in 2019 and 2020, pushing governments and the private sector to adopt a more careful approach to spending. We view the recent oil recovery as somewhat fragile and note that forward curves indicate market expectations of lower prices in the future.

Furthermore, we expect geopolitical risk to remain high, with pressure on some strategic sectors such as real estate in the UAE and Qatar. We think lower oil prices and geopolitical risk, combined with a few pressure points stemming from the global economy, will continue to weigh on consumer sentiment, prompting lower spending--especially if financed with debt.

Chart 1 - Asset Growth of Islamic Versus Conventional Banks (2013-2020)



Source: S&P Global Ratings, GCC Central Banks.

Table 1 - Balance Sheet Growth In Selected GCC Islamic Bank Markets (2013-2018)

(Mil. $)	2013	2014	2015	2016	2017	2018
Qatar	58,098	69,419	81,381	87,866	95,756	94,800
Annual growth rate (%)	12.0	19.5	17.2	8.0	9.0	(1.0)
Relative weight is sample (%)	16.5	17.6	19.3	19.6	19.9	19.1
Kuwait	78,457	85,688	83,461	83,560	89,138	92,849
Annual growth rate (%)	8.0	9.2	(2.6)	0.1	6.7	4.2
Relative weight is sample (%)	22.3	21.7	19.8	18.6	18.6	18.7
Saudi Arabia	107,412	121,264	124,563	136,138	140,366	149,102
Annual growth rate (%)	8.0	12.9	2.7	9.3	3.1	6.2
Relative weight is sample (%)	30.6	30.8	29.6	30.3	29.2	30.1
United Arab Emirates	86,212	94,203	107,392	118,014	129,471	134,943
Annual growth rate (%)	16.0	9.3	14.0	9.9	9.7	4.2
Relative weight is sample (%)	24.6	23.9	25.5	26.3	27.0	27.2
Total	351,116	394,026	421,401	448,993	480,176	495,503

The Cost Of Risk Should Increase Slightly

GCC Islamic banks' asset-quality indicators stabilized in 2018, with the nonperforming financing ratio averaging 3.1% of total financings for the banks in our sample. Provisions more than covered these exposures with a coverage ratio of 167.7% on the same date. This was an improvement over 2017 thanks to the adoption of International Financial Reporting Standards (IFRS) 9 or Financial Accounting Standard (FAS) 30 for banks reporting under Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standards.

Also, last year, Islamic banks' asset quality indicators did not deteriorate as did those of conventional banks, which saw their nonperforming loan (NPL) ratio increase to 3.1% on average from 2.7% at end-2017. We attribute this development to the clean-up and write-off operations of some Islamic banks in our sample, rather than a genuine improvement in asset quality.

We think that Islamic banks' asset quality should be similar, if not slightly weaker than that of conventional banks in the GCC. This is because both bank types are comparable, with businesses primarily comprising the collection of deposits and extending of finance to the real economy in their countries. Furthermore, Islamic banks tend to have higher exposure to the real estate sector due to the asset-backing principle inherent to Islamic finance. We also note that Islamic banks cannot charge late payment fees, unless they are donated to charities at the end of the exercise, meaning that clients tend to prioritize payments on conventional rather than Islamic exposures.

However, with the transition to IFRS9/FAS 30, Islamic and conventional banks will even more closely align. At end-2018, the average Stage 2 exposure for Islamic banks in our sample reached 10% of total exposure. It is worth mentioning that this number is just indicative as it includes an estimation of Stage 2 exposure for Kuwaiti Islamic banks, which are yet to publish their numbers. The amount of Stage 2 financing to total financing was 11.2% at end-2018 excluding our estimates for Kuwait.

We expect problematic assets to stabilize at about 15% of total assets in the next 12-24 months, with some transitions between Stage 2 and Stage 3 given the pressure on the real estate and contracting sector in some countries.

Another trend is the significant increase in Islamic banks' coverage ratios at end-2018, coupled with a stable cost of risk (excluding outliers) that is lower than conventional banks. Banks have taken the opportunity of IFRS 9 transition to set aside as many provisions as they can, given that the opening impact is charged to equity and not to income.

In addition, due to the asset backing principle of Islamic finance, banks tend to have more collateral than their conventional peers, at least in theory. This results in a lower loss given default (LGD) assumption and ultimately lower cost of risk. We believe that collateral realization is still difficult in the GCC although some authorities have implemented more creditor-friendly regulations over the past few years. In our base-case scenario, we expect cost of risk for Islamic banks, in our sample, to increase slightly in the next 12-24 months.

Table 2 - Asset-Quality Of Islamic Versus Conventional Banks (2013-2018)

(%)	2013	2014	2015	2016	2017	2018
Islamic banks						
Non performing advances ratio	4.2	3.3	3.0	3.1	3.2	3.1
Non performing advances coverage	106.5	114.2	128.4	135.3	131.6	167.7
New loan loss provisions (LLP) /average customer loans	1.00	0.92	0.95	0.83	0.74	0.65
Conventional banks						
Non performing advances ratio	3.5	2.9	2.5	2.7	2.7	3.1
Non performing advances coverage	133.0	167.7	168.4	158.0	153.6	168.1
New loan loss provisions / average customer loans	1.01	0.87	0.92	1.18	1.06	1.09

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

Liquid Assets Should Improve Despite Slowing Deposit Growth

GCC Islamic banks' saw customer deposits growth halve to 2.5% in 2018, compared with 6.4% in 2017, on the back of the relinquishing some expensive deposits and the depreciation of the Turkish lira, which affected the U.S.-dollar denominated financial results of some banks in our sample. However, thanks to relatively muted loan growth, the funding profile of these banks remained stable and comparable with conventional peers. The ratio of financings to total deposits stood at 92.6% for Islamic banks in our sample at end-2018 and we do not expect major changes in the funding and liquidity profile in 2019-2020.

The stabilization of oil prices at $60/bbl and muted loan growth mean that Islamic and conventional banks will continue to accumulate deposits over the next few years. This should also lead to an increase in liquid assets held by banks, which stood at 21.4% of total assets at end-2018, in particular sukuk. Islamic and conventional banks' funding profiles remain a strength in most GCC countries. This is shown in our Banking Industry Country Risk Assessments (BICRAs) through our assessment of systemwide funding, which positively influences our assessed starting point of some bank ratings. Islamic banks tend to attract retail depositors due to their Sharia-compliant nature. The use of wholesale funding sources remains relatively limited and it will not change anytime soon.

Table 3 - GCC Islamic Banks' Key Funding and Liquidity Metrics (2013-2017)

(%)	2013	2014	2015	2016	2017	2018
Growth in customer deposits	N.A.	14.0	6.0	5.4	6.4	2.5
Liquid assets/total assets	24.7	23.4	22.1	21.3	21.0	21.4
Customer loans (net)/customer deposits	87.1	88.8	92.3	93.2	93.3	92.6

N.A.--Not available. Source: S&P Global Ratings, banks' financial statements.

We Expect Plateauing Profitability Growth In 2019-2020

We anticipate that GCC Islamic banks will see little profit growth in 2019 and 2020. In the past 12 months, the return on assets of banks in our sample improved marginally due to lower cost of risk, because the opening effect of IFRS9 is charged to banks' equity statements.

We expect financing growth to remain limited, with banks prioritizing quality over quantity and avoiding lucrative but higher risk exposures. This is especially the case given that IFRS 9/FAS 30 requires lifetime provisioning for exposures that deteriorate in credit quality or see repayment issues.

While we expect the amount of problematic assets to remain somewhat stable, we think that cost of risk will increase slightly because of higher provisioning requirements under IFRS9. This is somewhat tempered by the presence of a real underlying asset for each Islamic transaction, at least in theory, which reduces the LGD assumptions.

We project that banks' operating costs will stabilize and they will increase their focus on efficiency gains due to lower growth opportunities. However, banks should benefit from a bounty of free deposits, especially with the pause in international and local interest rate rises.

Our base-case scenario excludes any escalation of geopolitical risk in the region or a major drop in oil prices. If that were to happen, the effect on both Islamic banks and conventional banks could be significant.

Table 4 - GCC Islamic Banks' Return On Assets (2013-2018)

(%)	2013	2014	2015	2016	2017	2018
Average intermediation margin	2.8	2.8	2.7	2.5	2.6	2.5
New loan loss provisions/average customer loans	1.0	0.9	0.9	0.8	0.7	0.5
Return on assets	1.5	1.5	1.6	1.4	1.5	1.6
Non interest expenses/operating revenues	41.5	40.7	39.1	40.7	40.6	41

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

Banks Are Inching Closer To Profit And Loss Sharing

The GCC Islamic banks included in our sample continue to display strong capitalization by international standards, with an unweighted average Tier 1 ratio of 17.1% at end-2018. The roughly 50-basis-point decline in this ratio compared with 2017 is due to some banks' more aggressive dividend policies and IFRS9 implementation.

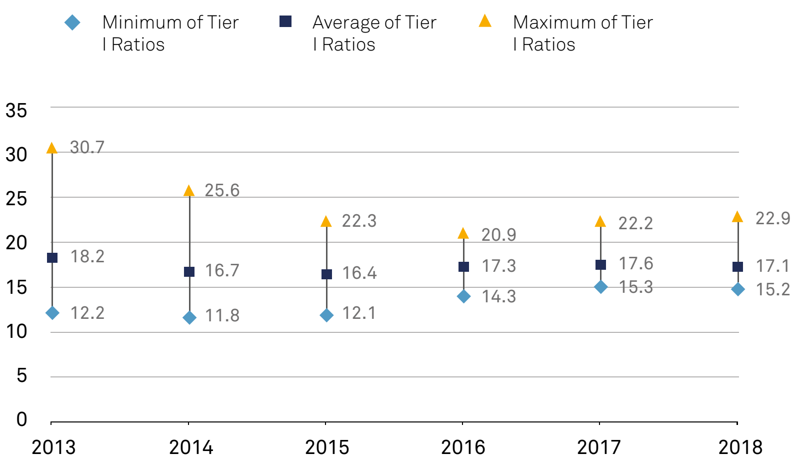
However, several banks in our sample have issued capital-boosting sukuk, primarily those in the UAE, Qatar, and Saudi Arabia. The common characteristic of these sukuk is that they allow for loss absorption at some point--generally at the issuer's discretion for Tier 1 sukuk. We believe these sukuk will help the industry progress toward one of its cardinal principles--profit and loss sharing. We incorporate some of these instruments, which allow the issuer to defer the periodic distribution of payments on a discretionary basis, in our total adjusted capital calculation.

It is our understanding that Oman is the only GCC country to progress toward a recovery and resolution regime. The sultanate recently approved a framework but the implementation timeline is unclear. We believe rolling out these regimes would require a profound change in the mentality and approach to bank support. GCC governments have not hesitated to rescue banks, as shareholders or to safeguard the financial stability of their banking systems.

There is a common perception that recovery and resolution regimes should be easy to implement in Islamic finance, due to the principle of profit and loss sharing. This means, in theory, natural and automatic bail-in, but we recognize there is additional complexity for the following reasons:

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

Chart 2 - GCC Islamic Banks' Reported Tier 1 Ratios (2013-2018)



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

Composition Of Our Sample

In order to assess the financial performance of Islamic and conventional banks in the GCC, S&P Global Ratings has used a sample of 17 Islamic banks and 27 conventional banks with total assets in excess of $2.0 trillion and sufficient financial disclosures. We have not included the Islamic windows/activities of conventional banks, owing to a lack of disclosure and the risk of distortion of data. For example, because conventional banks' Islamic windows/activities benefit from wider group support in the form of funding or cost sharing.

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

	Country	Islamic Bank Ranking	Overall Ranking	Assets (bil. $)
Al Rajhi Bank	Saudi Arabia	1	5	97.3
Dubai Islamic Bank	United Arab Emirates	2	10	60.9
Kuwait Finance House	Kuwait	3	11	58.5
Qatar Islamic Bank Q.P.S.C.	Qatar	4	15	42.1
Abu Dhabi Islamic Bank PJSC	United Arab Emirates	5	19	34.1
Bank Al-inma	Saudi Arabia	6	20	32.3
Masraf Al Rayan	Qatar	7	25	26.7
Al Baraka Banking Group B.S.C.	Bahrain	8	28	23.8
Bank Aljazira	Saudi Arabia	9	31	19.5
Emirates Islamic Bank PJSC	United Arab Emirates	10	32	15.9
Boubyan Bank K.S.C.P.	Kuwait	11	36	14.3
Qatar International Islamic Bank	Qatar	12	37	13.8
Ahli United Bank B.S.C.	Kuwait	13	38	12.9
Barwa Bank Q.S.C.	Qatar	14	39	12.2
Sharjah Islamic Bank	United Arab Emirates	15	40	12.2
Al Hilal Bank PJSC	United Arab Emirates	16	41	11.9
Kuwait International Bank K.S.C.P	Kuwait	17	44	7.1

*Ranking by total assets. GCC--Gulf Cooperation Council. Source: S&P Global Ratings.

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

	Country	Conventional Bank Ranking	Overall Ranking	Assets (bil. $)
Qatar National Bank (Q.P.S.C.)	Qatar	1	1	236.8
First Abu Dhabi Bank P.J.S.C.	United Arab Emirates	2	2	202.6
Emirates NBD PJSC	United Arab Emirates	3	3	136.2
The National Commercial Bank	Saudi Arabia	4	4	120.9
National Bank of Kuwait S.A.K.	Kuwait	5	6	90.3
Abu Dhabi Commercial Bank PJSC	United Arab Emirates	6	7	76.2
Samba Financial Group	Saudi Arabia	7	8	61.3
Riyad Bank	Saudi Arabia	8	9	61.3
Banque Saudi Fransi	Saudi Arabia	9	12	50.7
Arab National Bank	Saudi Arabia	10	13	47.5
The Saudi British Bank	Saudi Arabia	11	14	46.5
Mashreqbank	United Arab Emirates	12	16	38.1
The Commercial Bank of Qatar	Qatar	13	17	37.1
Ahli United Bank B.S.C.	Bahrain	14	18	35.5
BankMuscat S.A.O.G.	Oman	15	21	31.9
Arab Banking Corp. B.S.C.	Bahrain	16	22	29.5
Union National Bank PJSC	United Arab Emirates	17	23	29.1
Gulf International Bank B.S.C.	Bahrain	18	24	27.5
Doha Bank Q.P.S.C.	Qatar	19	26	26.4
Burgan Bank	Kuwait	20	27	24.1
Al Awwal Bank	Saudi Arabia	21	29	21.9
Gulf Bank	Kuwait	22	30	19.8
Al Ahli Bank of Kuwait K.S.C.P.	Kuwait	23	33	15.0
Commercial Bank of Kuwait	Kuwait	24	34	14.7
The National Bank of Ras Al-Khaimah	United Arab Emirates	25	35	14.3
Ahli Bank Q.S.C.	Qatar	26	42	11.1
National Bank of Fujairah PJSC	United Arab Emirates	27	43	10.8

*Ranking by total assets. GCC--Gulf Cooperation Council. Source: S&P Global Ratings.

Countdown To Brexit: Implications Of A No-Deal Brexit For Islamic Finance

Primary Credit Analyst:

Mohamed Damak
Dubai
(971) 4-372-7153
mohamed.damak
@spglobal.com

Secondary Contact:

Osman Sattar, FCA
London
(44) 20-7176-7198
osman.sattar
@spglobal.com

As we get closer to the scheduled Brexit date, investors are asking questions about the exposure of the Islamic finance industry, especially in the case of a "no deal." The U.K. is home to five fully fledged Islamic banks (all unrated; see table 1), with more than 15 other banks (affiliates of conventional banks) offering Islamic financial services. Given these banks' primary focus on U.K. domestic banking business, we see their exposure to Brexit risks as similar, if not more significant, to that of rated U.K. domestic banks (see "The 2019 Outlook For U.K. Banks Hinges On Brexit," published Jan. 10, 2019 on RatingsDirect). The potentially damaging effect of a no-deal Brexit on the U.K. economy and asset prices, particularly in real estate where most of the Islamic banks' activity is concentrated, will likely have a knock-on effect on U.K. Islamic banks' asset quality. However, we believe these banks' relatively strong capitalization provides a buffer against a slide in asset quality.

Key Takeaways

- A no-deal Brexit could have a significant negative impact on U.K.-based Islamic banks because their business remains concentrated on real estate financing. However, we do not expect a major disruption to their funding, since most of it is deposits.
- However, because of the small size of U.K. Islamic finance, we believe no deal will have a limited effect on global Islamic finance, as well as for sukuk structuring activities.
- The U.K. has always been a popular destination for real estate investment for investors in core Islamic finance countries, and a no-deal Brexit could nevertheless revive their appetite for the country's assets, assuming a significant drop in their prices.

Given the small size of U.K. Islamic finance compared to the U.K. domestic banking sector, we do not expect stresses arising in U.K. Islamic finance will lead to systemic risks for the U.K., or that a no-deal Brexit will make a difference to the global Islamic finance industry. In addition, local affiliates of U.K.-based law firms and banks, for example, in other financial centers such as Dubai, generally undertake sukuk structuring and, we also understand that only a few sukuk buy-to-hold investors are from the U.K. Finally, we do not see any reason why English law would be substituted as the law of choice for any sukuk contracts.
On a positive note, a no-deal Brexit could revive Islamic finance investors' appetite for U.K. assets, typically popular investments for investors in the Gulf, assuming a significant drop in their prices, due to lower valuations because of Brexit or a depreciation of the pound.

The risk of a no-deal Brexit on March 29, 2019, continues to be high, because it remains the default legal option in the absence for any agreed alternative. That said, we do not yet consider a no-deal outcome our base case for rating purposes, because we view the political incentive for the U.K. and the EU to negotiate an orderly outcome as still very strong.

Most of U.K.-based Islamic banks' business comprises lending with a focus on real-estate financing

According to the Islamic Financial Services Board (IFSB) database, the five U.K-based Islamic banks' total reported assets were £4.1 billion on June 30, 2018, which is less than 0.15% of the total size of the domestic assets of the U.K. banking system. There are no reported figures on the size of the Islamic assets of conventional banks providing Islamic financial services in the U.K., but we understand that it is also marginal. The banks' contribution to the global Islamic finance industry is also limited, at about 0.3% of total assets on June 30, 2018. Most of the Islamic banks' business comprises lending and remains concentrated on real estate financing, with total lending representing about 70% of total assets. The banks also invest in sukuk, accounting for about 11% of total assets on June 30, 2018, and 84% of their funding is from deposits, mostly via murabaha contracts. The banks' asset quality remains relatively good, with a nonperforming loans (NPLs) ratio of about 2.2%, according to the IFSB. However, their return on assets is modest, at 0.5% at mid-2018, mostly underpinned by their high cost base (84% cost to income ratio at mid-2018). These banks are also highly capitalized in conformance with local standards, with a total capital adequacy ratio of 21.4% and a tier 1 capital ratio of 19.9%. Finally, the banks' liquidity appears adequate, with their liquidity coverage ratio at 256%.

Table 1 - U.K.-Based Islamic Banks And Their Shareholders

Bank	Country of Origin	Shareholders
Abu Dhabi Islamic Bank	United Arab Emirates	Abu Dhabi Islamic Bank
Al Rayan Bank	Qatar	Masraf Al Rayan
Bank of London and the Middle East	United Kingdom	Shareholders from Kuwait among others
Gatehouse Bank	United Kingdom	Shareholders from Kuwait among others
QIB UK	Qatar	Qatar Islamic Bank

Table 2 - Islamic Banks In The U.K.: Key Numbers

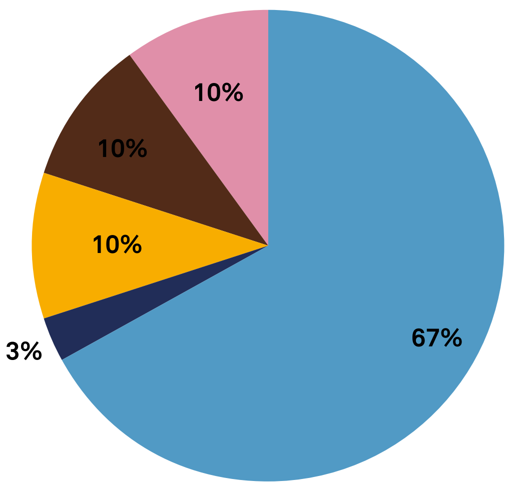
(Bil. US$)	2016	2017	1H2018
Assets			
Islamic bank assets U.K. (Bil. $)	4.2	5.1	5.5
Total Islamic bank assets	1,531	1,684	1,652
Capital			
Tier 1 capital ratio	21.7	21.0	19.9
Total capital ratio	22.6	22.3	21.4
Credit risk			
Foreign exchange lending to total lending	N.A.	14.2	12.3
Nonperforming financing ratio	N.A.	1.8	2.2
Nonperforming coverage ratio	N.A.	31.9	29.6
Profitability			
Return on assets	N.A.	0.6	0.5
Cost-to-income ratio	93.0	78.5	84.0
Funding and liquidity			
Liquid assets/total assets	12.9	14.8	11.6
Liquidity coverage ratio (x)	N.A.	3.9	2.6
Customer deposits/funding base		91.4	83.9
Total financings to deposits		89.4	110.1

N.A.--Not available. Sources: IFSB, S&P Global Ratings.

The negative affect of no-deal Brexit on the U.K. economy could damage Islamic banks' asset quality, particularly in real estate

In our view, a no-deal Brexit could push the U.K. into recession and reduce the economy's long-term growth potential. Our no-deal scenario indicates that U.K. GDP will contract by a cumulative 2.9% over two years, and that unemployment will reach 7.3% by 2021. This would lead to rising personal and corporate insolvencies and weaker collateral values. In time, this will likely reduce U.K.-based Islamic banks' asset quality and activity, undermining their earnings and possibly capitalization, especially because three-quarters of activity is denominated in local currency. Islamic banks' asset quality and earnings could also be hit harder than those of their conventional counterparts due to the significant concentration of their lending portfolio on real estate activities (see chart 1), which could suffer the most in the case of a no-deal Brexit. Our no-deal scenario anticipates a cumulative 9.5% drop in housing prices over two years. We have already observed some signs of weaknesses in Islamic banks' asset quality indicators, with a NPLs ratio of 2.2% at mid-2018, compared with 1.8% at year-end 2017. This is a result of the U.K. economy's somewhat weaker performance following the referendum. Coverage of NPLs by provisions was also a relatively low 29.6% at mid-2018.

Chart 1 - Sector Concentration Of U.K. Islamic Bank Financing



*20 sectors and no specific concentration. Sources: IFSB, S&P Global Ratings.

While any disruption in the wholesale funding market following Brexit would be unhelpful for the conventional banking sector as a whole, we note that Islamic banks' funding is mostly based on deposits, mitigating this risk. Spread widening or funding disruption for the banks and other U.K. corporates could be more acute if the market perceives that the creditworthiness of the U.K. sovereign has weakened. In our view, the Bank of England (BoE) would likely provide additional funding facilities to banks and possibly reduce interest rates if it saw an increased likelihood of the banking system coming under stress from a disorderly Brexit. This could be similar to the BoE's actions after the result of the 2016 referendum when it introduced the term funding scheme and cut interest rates. It remains to be seen if Islamic banks in the U.K. will need or receive additional funding from the BoE, and in what form. However, U.K.-based Islamic banks' profiles suggest that they are unlikely to need it, thanks to being mostly deposit funded and their adequate liquidity.

Assuming no major impact on the global economy or commodities prices, Brexit will have limited impact on the global Islamic finance industry due to the U.K.'s limited overall contribution to this industry. Several U.K. and European banks continue to play an important role in some core Islamic finance countries, such as Gulf Cooperation Council countries, but most of these banks' business is through local affiliates and is therefore unlikely to be disrupted by a no-deal Brexit. Operationally, Brexit may result in some challenges for sukuk structuring and listing, although most of the structuring work is done by the local affiliates of major European or U.K. law firms and local subsidiaries of investment banks, and therefore is also unlikely to be significantly affected. Finally, the most important contracts in sukuk structuring are typically based on English law and we do not anticipate this will change after Brexit.

The U.K. has always been a popular destination for real estate investment for Islamic finance investors. Thus, a no-deal Brexit, which might lead to a significant decline in real estate prices and depreciation of the pound, could further increase the appetite of these investors for U.K. asset classes. However, this appetite will also depend on how oil prices evolve throughout the year. In our base-case scenario, we currently assume that oil prices will average $55 in 2019. As always, a combination of geopolitical flashpoints, fresh U.S. shale supply, and uncertain growth conditions make forecasting oil prices a highly uncertain business. Therefore, it is difficult to assess to what extent, if any, real-estate investments will increase following Brexit.

Related Research

- Countdown To Brexit: Rating Implications Of A No-Deal Brexit, Feb. 20, 2019
- The 2019 Outlook For U.K. Banks Hinges On Brexit, Jan. 20, 2019
- Countdown To Brexit: Research By S&P Global Ratings, Dec. 10, 2018
- Countdown to Brexit: No Deal Moving Into Sight, Oct. 30, 2018

This report does not constitute a rating action.

IFSB Proposal On Sharia-Compliant Lender Of Last Resort Facilities: Moving In the Right Direction

Primary Credit Analyst:
Mohamed Damak
Dubai
(971) 4-372-7153
mohamed.damak
@spglobal.com

Secondary Contact:
Dhruv Roy
Dubai
(44) 20-7176-6709
dhruv.roy
@spglobal.com

Additional Contact:
Financial Institutions Ratings Europe
FIG_Europe@
spglobal.com

(Editor's note: Here, S&P Global Ratings responds to a draft guidance note by the Islamic Financial Services Board published on May 7, 2019. The views expressed in this response represent those of S&P Global Ratings and do not address, nor do we intend them to address, the views of any other affiliate or division of Standard & Poor's Financial Services LLC. We intend our comments to address the analytical needs and expectations of our credit analysts, as well as the questions we receive from investors. Our comments on the consultative document do not affect our ratings criteria.)

Key Takeaways

- The Islamic Financial Services Board (IFSB) has proposed a guidance note for central banks to establish and operationalize a Sharia-Compliant Lender of Last Resort (SLOLR) framework.
- S&P Global Ratings believes the proposal could help to level the playing field for Islamic banks and contribute to more stability in the Islamic finance industry.
- The proposal outlines a few instruments and details their shortcomings, but does not suggest an instrument that responds to all the requirements.
- A combination of some of the proposed instruments or the use of collateralized murabaha could help the implementation of SLOLR facilities.

The IFSB's proposal on Sharia-compliant LOLR facilities could, in our view, help boost the stability of the Islamic banking industry by minimizing banks' exposure to liquidity risks. Several core Islamic finance countries have not yet developed or formalized mechanisms to provide "last resort" support for Islamic banks. This disadvantages Islamic banks compared with their conventional peers' from a customer confidence and rating perspective. However, while the IFSB proposals could give Islamic banks an extra resource to meet liquidity needs in stress situations, we think that the proposed instruments would benefit from further refinement. For example, collateralized murabaha or a combination of the instruments highlighted by the IFSB could be used as tools to implement SLOLR facilities. Here, we outline the positives and shortcomings of the proposals and our expectation for how these instruments could be employed by central banks (CBs) of core Islamic finance countries.

Positive Aspects Of The Proposal

We expect core Islamic finance countries to gradually bring in formal mechanisms for providing last resort liquidity to support Islamic banks. Until this happens, Islamic banks in many of these countries remain at a disadvantage compared with their conventional counterparts. Support in case of need could still be forthcoming, however, despite the absence of a formal framework. In the case of liquidity issues, the regulators in some of these countries, have a track record of weighing up the different available options and providing support of some description. This is particularly the case in some Gulf Cooperation Council (GCC) countries where we believe the authorities are highly supportive toward their banking systems. The other positive is that the IFSB proposal encourages the increasing of the availability of liquidity management instruments such as the issuance of local currency (or foreign currency for countries that benefit from a peg) government sukuk. CBs are likely to use these instruments as underlying assets when they provide liquidity to Islamic banks operating in their systems. The lack of a liquidity management instrument has been one of the most prominent ongoing challenges for Islamic banks. The issue is slowly being resolved in the GCC countries. For example, Saudi Arabia has established an unlimited local currency sukuk program and is now issuing regularly in its local currency.

What Is Missing?

The IFSB has outlined some proposals on the instruments that CBs can use as well as their shortcomings. In the table below, we summarize the issues that may arise from the use of these different instruments.

Overview of the Islamic Financial Services Board's Proposed Instruments

Proposal	Positives And Shortcomings
Use of commodities murabaha	This is the preferred CB intervention, with mechanisms or windows in place to act as LOLR. Positives: It remains easy to implement, especially if there is already a well-oiled process for this type of transaction. Moreover, the rate of return on the transaction can be set from the onset. It is also usually punitive enough to ensure the instrument is used as a last resort rather than for business-as-usual. Shortcoming: One of the main issues lies in determining the basis for collateral transfer to the CB. Theoretically, a CB has no reason to receive additional collateral from these transactions as the commodities act as the underlying asset. This instrument therefore effectively provides liquidity on an unsecured basis, which is probably not the CB's intention. The proposal mentions that the collateral can be transferred to the CB in lieu of the commodity sale price but we think this might raise issues related to the change in the valuation of the collateral and the necessity to post additional collateral in case of decline of the valuation declines.
Mudaraba and Musharaka / Wakala bil Istithmar	Shortcomings: These instruments entail some profit and loss sharing mechanisms, potentially resulting in the CB taking a hit should losses occur. The rate of return to the CB is also based on the performance of the underlying assets, which means banks would have to pledge highly profitable and therefore risky assets. The pledge of the assets or the transfer of collateral would be effective under this type of instrument.
Qard	Shortcoming: This instrument is provided free of charge and therefore cannot qualify as an instrument of last resort. This could encourage banks to take excessive risks knowing that they would ultimately receive free liquidity support from the CB.

In our opinion, the instrument used has to combine the pledging of some assets (with a haircut), to minimize the risks for the CB, with a cost of funding that is sufficiently punitive to qualify as a last resort instrument. Two solutions appear fit for the purpose:

- Collateralized murabaha was developed and standardized by the International Islamic Financial Market in 2014. Using this instrument, banks can transfer some assets at a haircut to the CB, which can use commodity murabaha to set the parameters of the principal and the profit element. This could also resolve the issue highlighted in the table above as the collateral will be valued periodically. The bank might be required to post additional collateral in case the value of the collateral posted declines compared with the deferred sale price of the commodities, which would include the amount of liquidity support and the profit element.

- A combination of the instruments suggested by the IFSB that would ensure capital protection, presence of collateral or an underlying asset, and high cost of funding. It could take the form of a restricted deposit or a sukuk from the CB with identified underlying assets, a repurchase undertaking of the assets and/or a commodity murabaha part to set up the yield. This instrument would require the necessary approval of the CB's Sharia board or the specific banks' Sharia boards.

Why Are These Proposals Important To Our Ratings?

We believe that access to CB funding mechanisms is important because banks (including Islamic banks) are typically highly leveraged with significant maturity mismatches. Therefore, under our criteria, if a bank cannot access a CB funding mechanism, we cap our assessment of its funding at below average, which, depending on the bank's liquidity situation, could reduce or limit our view of its intrinsic creditworthiness. The lack of mechanisms for the recourse to the CB in case of need disadvantage Islamic banks compared with conventional banks.

Related Research

- GCC Islamic Banks Will Likely Stay Resilient In 2019-2020, May 6, 2019
- Countdown To Brexit: Implications Of A No-Deal Brexit For Islamic Finance, Feb. 18, 2019
- AAOIFI's Proposed Standards For Governance Of Sukuk Might Open The Door To Unforeseen Risks, Jan. 21, 2019
- Oil Prices Will Help Shape Sukuk Markets' Performance In 2019, Jan. 15, 2019

This report does not constitute a rating action.

AAOIFI's Proposed Standards For Governance Of Sukuk Might Open The Door To Unforeseen Risks

Primary Credit Analyst:

Mohamed Damak
Dubai
(971) 4-372-7153
mohamed.damak@spglobal.com

Secondary Credit Analyst:

Dhruv Roy
London
(44) 20-7176-6709
dhruv.roy@spglobal.com

Additional Contact:

Financial Institutions Ratings Europe
FIG_Europe@spglobal.com

(Editor's note: Here, S&P Global Ratings responds to a draft standard by the Accounting and Auditing Organization for Islamic Financial Institutions, approved by their Governance and Ethics Board on Nov. 8, 2018, and communicated to us on Dec. 31, 2018. The views expressed in this response represent those of S&P Global Ratings and do not address, nor do we intend them to address, the views of any other affiliate or division of Standard & Poor's Financial Services LLC. We intend our comments to address the analytical needs and expectations of our credit analysts, as well as the questions we receive from investors. Our comments on the consultative document do not affect our ratings criteria.)

Key Takeaways

- We believe AAOIFI's latest proposal regarding sukuk governance can help minimize risks of non-Sharia compliance after the transaction closes.
- However, proposals for independence of the SPV issuing the sukuk, the real transfer of assets to the SPV, and definition of the value of the assets could have unintended consequences.
- S&P Global Ratings' criteria for rating sukuk requires sufficiency of contractual obligations. Or, where investors have access to the underlying assets, our structured finance or corporate criteria could apply.

S&P Global Ratings believes the proposal by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) for sukuk governance, if implemented, can help boost the credibility of sukuk and minimize some of the risks, particularly those related to noncompliance with Sharia. On the other hand, we think that some of the proposals could open the door to unforeseen risks. While we have a generally positive view of the new requirements for Sharia governance and disclosures, we think three areas might present risks:

- The proposal to keep the special-purpose vehicle (SPV) issuing the sukuk totally independent from the sponsor,
- The requirement for the effective transfer of the underlying assets, and
- The requirements for the valuation of the underlying assets.

Most sukuk issued to date are based on contractual obligations of their sponsors. But if AAOIFI's proposal is implemented, the market might depart from this common practice and shift toward sukuk where repayment is based largely on the underlying assets themselves, including recourse to them under scenarios of default. However, in our view, the market appetite for such instruments is yet to be demonstrated. Therefore, two points that require clarification, in our opinion, are the mechanisms of recourse of investors in case of sukuk resolution and whether it would still be acceptable to issue sukuk where repayment relies solely on the contractual obligations of sponsors.

AAOIFI Sukuk Governance: The Positives

S&P Global Ratings believes that AAOIFI's proposals could help boost the credibility of sukuk and minimize the risks related to non-Sharia compliance. Among other requirements, the proposed standard specifies that:

- The sukuk's sponsors must ensure the assets are managed in line with their contractual obligations and no breach occurs.
- Sukuk are subject to an internal audit of its compliance with contractual terms, AAOIFI standards, regulatory requirements, and Sharia rules.
- Sukuk are subject to periodic oversight by the Sharia board with a process to escalate any risks related to noncompliance with Sharia to regulators and sukuk holders.

The proposal also:

- Recognizes the possibility of change in a Sharia ruling (fatwa) for specific reasons, such as significant changes in the business or operations or the originator or the sukuk assets, or a change in the relevance of the earlier Sharia standard that was applied, or any possible error in the original ruling. However, the standard requires that under such a scenario, any change in the legal documentation of the sukuk shall be based on the principle of justice and equity, and ensure that any revision in the Sharia standard causes minimum harm to sukuk holders. Moreover, the standard requires that any termination of the sukuk shall not result in an unjustifiable material loss to the sukuk holders.
- Requires an external Sharia audit of the sukuk at least once a year with reporting to the various stakeholders.

In our view, such provisions might help the sukuk market by reducing the risks of the instrument being seen as non-Sharia compliant. They can also minimize the risk of using Sharia compliance as a reason to avoid delivering on contractual obligations. In 2017 for example, Dana Gas reportedly defaulted on its sukuk, alleging a lack of Sharia compliance, which triggered lawsuits in the U.K. (the court rulings were in favor of sukuk holders) and in Sharjah. In the end, sukuk holders decided to settle with Dana Gas rather than try to enforce the U.K. judgment in Sharjah. Among other things, the Dana Gas case illustrates the potential additional risks to which sukuk holders might be exposed when dealing with Sharia-compliant products. It highlights the potential issues that arise when trying to enforce foreign judgments in local jurisdictions, especially when Sharia is the ultimate source of the law. Finally, Dana Gas also again moved the debate about standardization of legal documents and Sharia interpretation to the top of the agenda for policymakers.

AAOIFI Proposals: The Potential Unforeseen Risks

Here, we summarize the proposals made by AAOIFI that could in our opinion trigger unforeseen risks.

1. Appointment of an independent trustee
AAOIFI requires the appointment of an eligible and reliable trustee that:

- Understands and demonstrates compliance with Sharia,
- Is independent and objective,

- Demonstrates creditworthiness and financial stability, and

- Complies with best practices of relevant responsibilities.

Risks or issues. We see these requirements as a potentially disruptive change because currently the SPV issuing the sukuk generally acts as the trustee of the transaction. The SPV generally has no history of operations and is incorporated solely for the purpose of participation in the transaction. To ensure the protection of investors, usually the trustee unconditionally delegates its authority to a delegate, which is typically an independent party. It is therefore necessary that the standard clarify whether this is an acceptable solution.

2. SPV and transfer of the assets

In its proposal, the AAOIFI would require the sponsor neither have effective control nor management of the SPV nor direct or indirect equity stake in the SPV. Moreover, AAOIFI requires the absolute transfer of the assets to the SPV in a manner that creates a legal impediment for the sponsor or its creditors to have any legal rights over the assets in the event of bankruptcy of the sponsor.

Risks or issues. We are of the view that this requirement is contrary to market practices where the sponsor of the sukuk itself usually owns the SPV. The risks related to conflicts of interest are usually dealt with through the delegation of authority to an independent party. We believe that if the AAOIFI proposal is implemented as proposed, it could raise roadblocks for sovereign sukuk issuance as it might appear to be a disguised privatization, for example. The absolute transfer of the underlying assets is also contrary to market practices. While sukuk terms and conditions usually include provisions for transferring the underlying assets, we understand that issuers and investors don't want to make such a transfer and keep recourse only to the sponsor (and in no case to the underlying assets). The effective transfer of the underlying assets could provide some form of credit enhancement, whose benefits depend on many other factors, but might also weaken the credit quality of the sponsor (as it will be deprived of these assets).

3. The value of the assets

The standard requires that assets be transferred to the SPV at their fair market value or a value that is reasonably close to it. It also clarifies that in no case should sukuk assets be transferred between parties at a value considered inappropriate or exploitative for either party.

Risks or issues. This requirement is contrary to the market practice where the value and transfer of the asset is set at the onset of the transaction for its whole duration. Under the purchase undertaking, for example, the sponsor of the sukuk generally undertakes to buy back the underlying assets at a predetermined price equal to the principal of the transaction. While the legal language of the purchase undertaking is designed to protect investors against the risks that the sponsor might question this price, AAOIFI's proposal could open the door to such a scenario. It could also result in a loss for sukuk holders in jurisdictions where Sharia is the ultimate source of the law. The typical example would be a real estate company using some of its real estate assets as underlying assets for a sukuk issuance, refusing to execute a purchase undertaking on the ground that real estate assets have dropped in value and the exercise price of the purchase undertaking is no longer a reflection of the fair value of the assets.

We are therefore of the view that AAOIFI needs to clarify whether current market practices will still be acceptable when the standard is implemented. We believe that if the standard is implemented as proposed, the interest of issuers and investors in sukuk might decrease. Some of these requirements might also increase the complexity of sukuk and the costs related to issuance compared with conventional bonds, thereby reducing their attractiveness to issuers and investors.

Why Are These Proposals Important To Our Ratings?

S&P Global Ratings published its methodology for rating sukuk in January 2015, outlining the five conditions that a sukuk has to fulfill to achieve the same rating as on the sponsor. One of these conditions is the sufficiency of contractual obligations of the sponsor for the repayment of sukuk holders (principal plus all or the last periodic distribution amount in a scenario of early dissolution). However, AAOIFI's proposal to transfer the underlying assets from the sponsor to sukuk holders could change the way we look at these transactions. In that case, we could instead use either our structured finance methodology or our corporate methodology to rate the sukuk. If the corporate methodology applies, for the rating of an instrument to benefit from collateralization, the underlying asset has to be sufficiently liquid and of a good quality. The legal environment needs also to fulfill certain requirements. Furthermore, if several of the sponsor's assets are tied to its sukuk issuance, it could have negative consequences for the ratings. Finally, if sponsors can challenge their contractual obligations based on the change in the value of the underlying assets, the transaction might not be ratable due to lack of sufficiency of contractual obligations. Similarly, if the Sharia compliance of a transaction is questioned after the closing of the transaction and results in a significant change in the legal obligations of the sponsor, we might revise the rating--and even lower it to a very low rating category if we were to consider the changes akin to a distressed exchange.

Related Research

- Oil Prices Will Help Shape Sukuk Markets' Performance In 2019, Jan. 15, 2018
- The Future Of Banking: Islamic Finance Needs Standardization And FinTech To Boost Growth, April 16, 2018

This report does not constitute a rating action.

Stricter Capital Rules Could Accelerate Consolidation Among Gulf Islamic Insurers

Primary Credit Analyst:

Emir Mujkic
Dubai
(971) 4-372-7179
emir.mujkic
@spglobal.com

Research Contributor:

Ronak Chaplot
CRISIL Global Analytical Center, an S&P affiliate, Mumbai

Additional Contact:

Insurance Ratings Europe
insurance_
interactive_
europe@spglobal.
com

S&P Global Ratings believes that plans to increase minimum capital requirements will lead to consolidation in the Gulf Cooperation Council (GCC) Islamic insurance industry (takaful and Islamic cooperative tawuni), where weak profitability has posed problems.

Thanks to strong premium growth in Saudi Arabia and other GCC markets, Islamic insurers in the region recorded a 9.5% increase in gross written premiums and contributions in first-quarter 2019 following years of flat growth and declining profitability. This was joined with a 13.4% increase in profits, mainly from better investment returns.

Key Takeaways

- We expect stricter capital requirements in a number of Gulf countries will speed up consolidation in the Islamic insurance sector.
- This comes after years of flat growth and declining profitability--despite an increase in first-quarter 2019.
- Overall profitability remains weak, with about one-third of companies continuing to generate underwriting losses.

However, despite these material improvements, we note that more than one-third of insurers in the sector continue to report underwriting losses. Accumulated losses have in recent years eroded capital buffers and resulted in solvency issues and temporary, or even permanent, license suspensions for a number of insurers, particularly in Saudi Arabia--the largest Islamic insurance market in the GCC. This also has led to a number of negative rating actions in recent years.

To strengthen the sector, the Saudi Arabian regulator (SAMA) is assessing plans to increase minimum capital requirements for primary insurers to Saudi riyal (SAR) 500 million, up from the current SAR100 million. Although details regarding the exact timing and amount have yet to be confirmed, an increase in minimum capital requirements of this magnitude would require almost 90% of insurers in the kingdom to raise new capital, consolidate through mergers and acquisitions, or exit the market entirely.

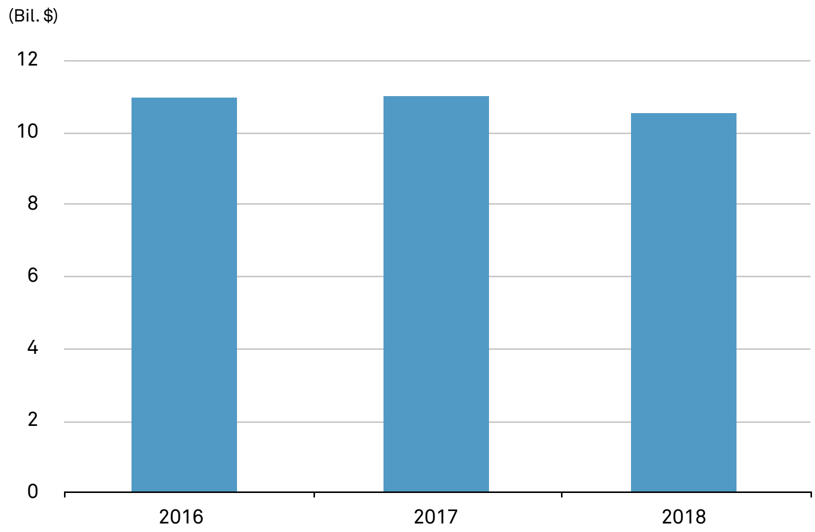
In other markets such as the United Arab Emirates (UAE), where about 40% of takaful players do not comply with new solvency requirements adopted in January 2018, and in Kuwait, where a new law with higher capital requirements could be implemented in 2020, a significant number of companies will also need to increase their capital or consolidate.

Weak Profitability Remains A Key Issue

Net income for Islamic insurers in the Gulf has significantly declined in recent years, according to our data. In 2018, the sector generated a net profit of about $281 million, compared with $383 million in 2017, and $674 million in 2016.

The weak results in the Saudi Arabian market, which contributes about 85% of total gross written premiums of all Islamic insurers in the GCC, have been the main source of earnings volatility in the sector in recent years. Slow economic activity and higher competition have also spurred the decline in profitability.

Chart 1 - GCC Islamic Insurers Have Seen Little To No Growth In Gross Written Premiums/Contributions In Recent Years



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

The market received a boost in first-quarter 2019, compared with the same quarter in 2018, with gross written premiums and contributions rising about 9.5% to $3.5 billion, and a 13.4% rise in net profit to about $77 million. Premium income in Saudi Arabia increased by 8.8%, mainly due to a rise in medical business following the introduction of mandatory cover for dependents of Saudi nationals, while takaful companies in other GCC markets expanded at an even faster rate of about 14%, supported by growth across several lines of business. At the same time profitability improved largely thanks to better investment results. This was supported by strong recoveries in equity markets in first-quarter 2019, following a significant decline in fourth-quarter 2018.

We expect net income will improve in 2019, compared with 2018, but moderate over the remaining quarters of the year. However, the improvement is likely to be spurred by better investment returns, not market conditions, which we expect will remain highly competitive.

Regulators Want Fewer But Stronger Companies

Some GCC insurers have been unable to cope with increased competition and stricter laws and regulations. In particular, a legislative change in Kuwait in early 2019, requiring insurers to pay motor claims within a few weeks rather than several months, exposed significant liquidity deficits among a number of smaller takaful players. This led to the temporary suspensions of at least six companies. We believe that the planned introduction of a new insurance law with higher capital requirements in 2020 could increase the pressure on the large number of small and unprofitable takaful players in Kuwait that will need to raise new capital to meet these requirements.

In Saudi Arabia, accumulated losses that have eroded the capital of a number of insurers over the past few years have also led to temporary or even permanent suspensions. As a result, three of the 34 insurers, representing almost 10% of companies in the market, have stopped their operations.

To create stronger companies, the Saudi regulator has been studying proposals to increase minimum capital requirements to SAR500 million from the current SAR100 million. We believe only a small number of the 31 active primary insurers in the kingdom currently meet these requirements, which means almost 90% would need to raise new capital. Although details of the exact timing and amount have yet to be confirmed, some insurers have already taken steps to increase their capital levels by raising new funds, retaining a higher proportion of their profits, or assessing merger options.

Chart 2 - Only A Small Number Of Saudi Insurers Would Meet The Proposed SAR500 Million Minimum Capital Target*

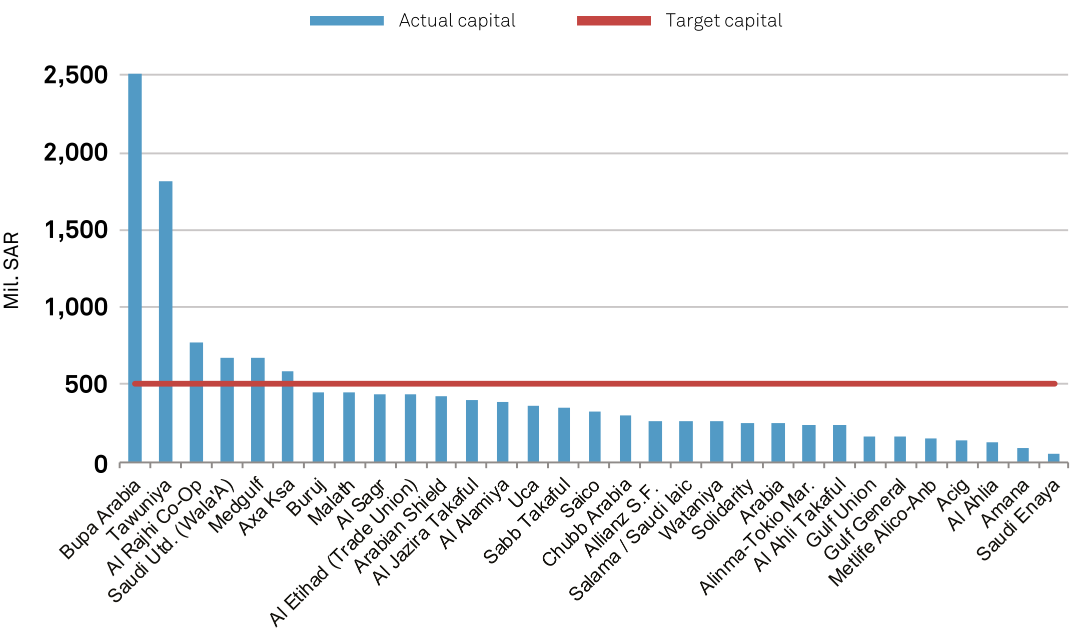


*Chart shows total capital at year-end 2018. SAR--Saudi riyal.

We also estimate that about 40% of takaful players in the UAE do not meet new solvency regulations adopted in early 2018 and that these companies will need to take action to restore their capital levels in the near future.

Although consolidation in the Islamic, as well as conventional, insurance industry in the Gulf has been overdue, it has historically been prevented by public stock market valuations that do not reflect economic fundamentals, which has created a significant valuation gap. Consolidation has also been held back by shareholders and management teams, who are often reluctant to relinquish control because their positions and status could be diminished within larger entities. However, we believe that tougher regulatory requirements will eventually kick-start consolidation in the sector, particularly since not every insurer needing to increase its capital will be able to do so.

Overall, while a number of small and medium-sized entities operate successfully, we believe the consolidation of the GCC insurance market would help improve the operational scale and capital base of companies. This should allow them to retain more risk, while also easing highly competitive market conditions.

Related Research

- Saudi Insurance Market Sees Another Profit Decline In 2018, April 9, 2019
- Some GCC Insurers Will Increasingly Feel The Heat In 2019, Feb. 25, 2019

This report does not constitute a rating action.

List of Islamic Banks and Takaful Companies Rated by S&P Global Ratings

Issuer	Country	Type	Rating as of June 30, 2019
Al Baraka Banking Group B.S.C.	Bahrain	Bank	BB/Negative/B
Hannover ReTakaful B.S.C.	Bahrain	Insurance	A+/Stable/--
Bank Islam Brunei Darussalam Berhad	Brunei	Bank	A-/Stable/A-2
Jordan Islamic Bank	Jordan	Bank	B+/Stable/B
Wethaq Takaful Insurance Company K.S.C.P.	Kuwait	Insurance	B/ Negative / --
Al Khaleej Takaful Group (Q.P.S.C.)	Qatar	Insurance	BBB/Stable/--
Qatar Islamic Bank (S.A.Q.)	Qatar	Bank	A-/Stable/A-2
Al Rajhi Bank	Saudi Arabia	Bank	BBB+/Stable/A-2
Al Sagr Cooperative Insurance	Saudi Arabia	Insurance	BBB-/Watch Neg/--
Islamic Development Bank	Saudi Arabia	Multinational	AAA/Stable/A-1+
Mediterranean & Gulf Cooperative Insurance and Reinsurance Co.	Saudi Arabia	Insurance	B/Positive/--
The Company for Cooperative Insurance	Saudi Arabia	Insurance	BBB+/Negative/--
Wataniya Insurance Company	Saudi Arabia	Insurance	BBB/Positive/--
Islamic Corporation for Development of the Private Sector	Saudi Arabia	Multinational	A/Negative/--
AlBaraka Turk Katilim Bankasi AS	Turkey	Bank	B/Negative/B
Islamic Arab Insurance Co. (Salama)	UAE	Insurance	BBB-/Stable/--
Sharjah Islamic Bank	UAE	Bank	A-/Stable/A-2

Sukuk currently rated by S&P Global Ratings

Obligor	Country	Sukuk/Trust certificates	Sector	Date of Rating	Porgram or Issued ($-eq Mn)
Emirate of Ras Al Khaimah	UAE	RAK Capital	Gov.	2008	2,000
Government of Malaysia	Malaysia	Wakala Global Sukuk Bhd.	Gov.	2011	800
State of Qatar	QAT	SoQ Sukuk A Q.S.C.	Gov.	2011	4,000
Islamic Development Bank	Saudi A.	IDB Trust Services Ltd.	Gov.	2011	25,000
Republic of Indonesia	Indonesia	Perusahaan Penerbit SBSN Indonesia III	Gov.	2012	25,000
Saudi Electric Co.	Saudi A.	BSF Sukuk	FI	2012	2,000
Saudi Electric Co.	Saudi A.	Saudi Electricity Global Sukuk Co.	Corp.	2012	1,250
Majed Al Futtaim	UAE	MAF Sukuk Ltd.	Corp.	2012	1,500
Axiata Group Bhd.	Malaysia	Axiata SPV2 Bhd.	Corp.	2012	1,500
IILM	Malaysia	International Islamic Liquidity Management 2 SA's	SF	2013	3,000
Saudi Electric Co.	Saudi A.	Saudi Electricity Global SUKUK Co. 2	Corp.	2013	2,000
Mumtalakat	Bahrain	Bahrain Mumtalakat Holding Co. Sukuk Programme	Gov.	2014	1,000
Goldman Sachs Group Inc.	Cayman	JANY Sukuk Company Limited	FI	2014	500
Hong Kong (Special Administrative Region)	HK [China]	Hong Kong Sukuk 2014 Ltd.	Gov.	2014	1,000
Luxembourg	Luxembourg	Luxembourg Treasury Securities SA	Gov.	2014	227

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

Obligor	Country	Sukuk/Trust certificates	Sector	Date of Rating	Porgram or Issued ($-eq Mn)
Pakistan	Pakistan	The Second Pakistan International Sukuk Company Limited	Gov.	2014	1,000
Ooredoo (Tamweel)	QAT	Ooredoo Tamweel Ltd.	Corp.	2014	2,000
Saudi Electric Co.	Saudi A.	Saudi Electricity Global Sukuk Co. 3 (tranches 1 & 2)	Corp.	2014	2,500
Republic of South Africa	South A.	Republic of South Africa Sukuk No. 1 Trust	Gov.	2014	500
DIFC Investment LLC.A21:F49	UAE	DIFC Sukuk. Ltd	Corp.	2014	700
Damac Real Estate Development	UAE	Alpha Star Holding Ltd.	Corp.	2014	650
Emaar Malls Group LLC	UAE	EMG Sukuk Ltd	Corp.	2014	750
Emaar Properties PJSC	UAE	Emaar Sukuk Ltd.	Corp.	2014	2,000
Emirate of Sharjah	UAE	Sharjah Sukuk Limited	Gov.	2014	750
Hong Kong (Special Administrative Region)	HK [China]	Hong Kong Sukuk 2015 Ltd.	Gov.	2015	1,000
Government of Malaysia	Malaysia	Malaysia Sovereign Sukuk Bhd.	Gov.	2015	1,500
Petroliam National Berhad	Malaysia	Petronas Global Sukuk	Corp.	2015	1,250
Albaraka Turk Katilim Bankasi AS	Turkey	Albaraka Sukuk Ltd.	FI	2015	250
International Finance Corp.	U.S.A.	IFC Sukuk Co.	Gov.	2015	100
Central Bank of Bahrain	Bahrain	CBB International Sukuk Company 5 S.P.C.	Gov.	2016	1,000
Government of Malaysia	Malaysia	Malaysia Sukuk Global Berhad	Gov.	2016	1,500
Hilal Services Ltd.	Saudi A.	ICDPS Sukuk Limited	Gov.	2016	300
Emirate of Sharjah	UAE	Sharjah Sukuk 2 Ltd.	Gov.	2016	500
Ezdan Sukuk Company Ltd.	QAT	Ezdan Sukuk Company Ltd.	Corp.	2016	2,000
Pakistan	Pakistan	The Third Pakistan International Sukuk Company Limited	Gov.	2017	1,000
Damac Real Estate Development	UAE	Alpha Star Holding III Limited	Corp.	2017	500
Government of Hong Kong	China	Hong Kong Sukuk 2017 Ltd.	Gov.	2017	1,000
Equate Petrochemical	Kuwait	EQUATE Sukuk SPC Limited	Corp.	2017	2,000
Central Bank of Bahrain	Bahrain	CBB International Sukuk Company 6 S.P.C.	Gov.	2017	850
Central Bank of Bahrain	Bahrain	CBB International Sukuk Co S.P.C. 7	Gov.	2018	1,000
Damac Real Estate Development	UAE	Alpha Star Holding V Limited	Corp.	2018	400
Tolkien Funding Sukuk No. 1 PLC	UK	Tolkien Funding Sukuk No. 1 PLC	SF	2018	318
Emirate of Sharjah	UAE	Sharjah Sukuk Programme Limited	Gov.	2018	1,200
Emirates of Sharjah	UAE	Sharjah Sukuk Programme Limited	Gov.	2019	1000
Saudi Telecom Company	Saudi A.	STC Sukuk Co.	Corp.	2019	5000
Almarai Company	Saudi A.	Almarai Sukuk	Corp.	2019	2000
Serba Dinamik Holdings Bhd.	Malaysia	SD International Sukuk Limited	Corp.	2019	300

Primary Credit Analyst:

Mohamed Damak
Dubai
(971) 4-372-7153
mohamed.damak@spglobal.com

The Five Pillars Of Islamic Finance

The ban on interest

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

The ban on uncertainty or speculation

Uncertainty in contractual terms and conditions is forbidden. However, risk taking is allowed when all the terms and conditions are clear and known to all parties.

The ban on financing certain economic sectors

Financing of industries deemed unlawful by Sharia--such as weapons, pork, and gambling--is forbidden.

The profit- and loss-sharing principle

Parties to a financial transaction must share in the risks and rewards attached to it.

The asset-backing principle

Each financial transaction must refer to a tangible, identifiable underlying asset.

Vocabulary Of Islamic Finance

Bay salam

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

Diminishing musharaka

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

Gharar

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

Halal

Lawful; permitted by Sharia.

Hamich Jiddiya

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

Haram

Unlawful; prohibited by Sharia.

Ijara

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

Ijara muntahia bittamleek

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

Ijara wa iqtina

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

Investment risk reserve

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

Istisna

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

Mudaraba

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

Profits generated by such an enterprise or activity 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.

Regional Management

Bernard De Longevialle
Managing Director
Lead Analytical Manager
EMEA Financial Services
Paris
+33140752517

Hadi Melki
Managing Director &
Regional Head Middle East
Dubai
+97143727170

Dhruv Roy
Senior Director &
Analytical Manager
Dubai
+97143727169

Dr. Mohamed Damak
Senior Director & Global Head
of Islamic Finance
Dubai
+97143727153

Meshari Al-Khaled
Managing Director and
Office Head – Saudi Arabia
Riyadh
+966112118160

Financial Institutions

Samira Mensah
Director
Johannesburg
+27112144869

Benjamin Young
Director
Dubai
+97143727181

Puneet Tuli
Rating Analyst
Dubai
+97143727157

Corporates

Timucin Engin
Senior Director
Cross-Practice Country Coordinator
GCC Region – Dubai
+97143727169

Sapna Jagtiani
Associate Director
Dubai
+ 97143727122

Vishal Kulkarni
Associate Director
Singapore
(65) 6216-1047

Sovereign

Max McGraw
Associate
Dubai
+97143727168

Insurance

Emir Mujkic
Director
Dubai
+97143727179

Structured Finance

Irina Penkina
Director
Moscow
+74957834070

Commercial and Market Engagement

Jawad Ameeri
Director,
Business Development
Dubai
+97143727160

Mohamed Ali
Associate Director,
Market Engagement
Dubai
+97143727146

Notes

Notes

spglobal.com