



# Islamic Finance Outlook

2021 Edition

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**S&P Global**  
Ratings





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## 2021

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# Islamic Finance 2020-2021

## COVID-19 OFFERS AN OPPORTUNITY FOR TRANSFORMATIVE DEVELOPMENTS

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

S&P Global Ratings believes that global Islamic finance industry growth will slow significantly in 2020-2021 after strong performance in 2019 underpinned by a more dynamic sukuk market. This is due to the significant slowdown in core Islamic finance economies in 2020, amid measures implemented by various governments to contain the COVID-19 pandemic, and the expected mild recovery in 2021.

Despite the challenging environment, we see opportunities to accelerate and unlock the long term potential of the industry. In particular:

- 1- We think that Islamic finance **social instruments** can help core countries, banks, companies and individuals economically affected by the pandemic navigate current conditions, with market participants eyeing Qard Hassan, Zakat, Waqf, and Social Sukuk. The Islamic Development Bank (IsDB) was a first mover with its \$1.5 billion sustainability sukuk, which will reportedly be used to help member countries cope with the effects of the pandemic, particularly in the health care and small and midsize enterprises segments. We expect other similar issuances in core Islamic finance countries and believe they could help put the Islamic finance industry back on environmental, social, and governance (ESG) investors' radar.
- 2- We also believe that **streamlining sukuk issuance will restore its attractiveness to issuers**. Issuing sukuk remains more complex and time consuming than conventional bonds. As with previous crises, the pandemic has shown that when Islamic finance issuers need swift access to capital markets, they typically use conventional instruments. However, there are some exceptions including issuers with already-established programs or that can tap a recent issuance; issuers that are under stress and need to access all available funding sources; or issuers that are domiciled in jurisdictions where the sukuk process is streamlined. Because of the pandemic, stakeholders are realizing the importance of inclusive standardization.

- 3- Lockdown measures, implemented by various countries around the world, have also shown the importance of **leveraging technology and creating a nimbler Islamic finance industry**. Higher digitalization and fintech collaboration could help strengthen the resilience of the industry in a more volatile environment and open new avenues for growth. However, recent months have demonstrated that there is still room for improvement, particularly for sukuk issuance, compliance with regulations, and ease and speed of execution.

With the right coordination between different Islamic finance stakeholders, we believe the industry can create new sustainable growth opportunities that serve its markets. Moreover, thanks to its key principles, Islamic finance can help mitigate the effects of the pandemic on core countries and contribute to shared prosperity. However, the industry is more than ever in need of strong and decisive reforms to enhance this contribution. 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 2021 edition of our Annual Outlook For Islamic Finance, and as always, we welcome and encourage your feedback on our research and insights.



## التمويل الإسلامي 2020-2021: أزمة كوفيد-19 تكشف عن فرص تطوير جوهريّة في القطاع

د. محمد دمق

مدير أول والرئيس العالمي للتمويل الإسلامي

تعتقد وكالة "إس أند بي جلوبال" لتصنيفات الائتمانية أن نمو قطاع التمويل الإسلامي سيتباطأ بشكل ملحوظ في الفترة الممتدة ما بين 2020-2021، وذلك بعد أن حقق القطاع نمواً قوياً في العام 2019، بدعم من سوق الصكوك الذي كان أكثر حيوية ويفسر هذه التوقعات التباطؤ الملحوظ في اقتصادات الدول الأساسية للتمويل الإسلامي في العام 2020؛ نتيجةً للإجراءات التي اتخذتها العديد من الحكومات لاحتواء جائحة كوفيد-19، والتوقعات بتحقيق انتعاش معتدل في عام 2021.

وبالرغم من الظروف الحالية الصعبة، نرى بأن الفرص متاحة لإطلاق إمكانيات القطاع على المدى الطويل، وبالأخص ما يلي:

1- نعتقد بأن الأدوات المالية الاجتماعية في قطاع التمويل الإسلامي يمكن أن تساعد الدول الأساسية في القطاع، والبنوك، والشركات، والأفراد المتأثرين اقتصادياً بالتداعيات السلبية للجائحة، مع تطلع المشاركين في السوق للاستفادة من أدوات كالقرض الحسن، والزكاة، والوقف، والصكوك الاجتماعية. وكان البنك الإسلامي للتنمية أول من تحرك بهذا الاتجاه من خلال إصدار صكوك مستدامة بقيمة 1.5 مليار دولار أمريكي، والتي بحسب تقارير ستستخدم عائداتها لمساعدة الدول الأعضاء في البنك لمواجهة آثار الجائحة، على وجه الخصوص قطاعي الرعاية الصحية والمؤسسات الصغيرة والمتوسطة. نتوقع إصدارات أخرى مشابهة في الدول الأساسية للتمويل الإسلامي، والتي نعتقد بأنها من الممكن أن تساعد في عودة قطاع التمويل الإسلامي إلى دائرة اهتمام المستثمرين الذين يدعمون الأهداف البيئية والاجتماعية وحوكمة الشركات.

2- نعتقد أيضاً بأن تبسيط إجراءات إصدار الصكوك سيعيد جاذبيتها للمُصدّرين. تبقى إجراءات إصدار الصكوك معقدة بالمقارنة مع إجراءات إصدار السندات التقليدية. وكما حدث خلال الأزمات السابقة، أظهرت جائحة كوفيد-19 بأنه عندما يحتاج المُصدّرون في قطاع التمويل الإسلامي إلى الوصول السريع لأسواق رأس المال، فإنهم عادةً ما يلجؤون للأدوات التقليدية. مع ذلك، هناك بعض الاستثناءات، من بينها المُصدّرين الذين يملكون برامج إصدار قائمة حالياً أو القادرين على الاستفادة من الإصدارات الحديثة أو المُصدّرين الواقعيين تحت الضغوط ويحتاجون للوصول لجميع مصادر التمويل المتاحة أو المُصدّرين القائمين في دول فيها إجراءات إصدار الصكوك سلسلة. وبفعل الجائحة أدرك أصحاب المصلحة مدى أهمية وضع معايير موحدة.

3- لقد أظهرت إجراءات تقييد الحركة، التي فرضتها العديد من الدول حول العالم، مدى أهمية الاستفادة من التكنولوجيا وإنشاء قطاع تمويل إسلامي أكثر مرونة. إن زيادة التعاون بين التكنولوجيا الرقمية والتكنولوجيا المالية يمكن أن يساعد في

تعزيز استقرار القطاع في البيئات الأكثر تقلباً ويفتح آفاقاً جديدة للنمو. مع ذلك، أظهرت الأشهر الأخيرة بأنه لا يزال هناك مجال لتحقيق تقدم، لاسيما في إصدار الصكوك والامتثال للوائح التنظيمية، وسهولة وسرعة التنفيذ.

نعتقد بأن قطاع التمويل الإسلامي يمكن أن يخلق المزيد من فرص التنمية المستدامة التي تخدم الأسواق التي يتواجد فيها من خلال التعاون البناء بين مختلف أصحاب المصلحة في قطاع التمويل الإسلامي. علاوة على ذلك، إن المبادئ الأساسية التي يقوم عليها التمويل الإسلامي يمكن أن تساعد في التخفيف من آثار الجائحة على الدول الأساسية للقطاع والمساهمة في تحقيق الرخاء المشترك لهم. مع ذلك، إن القطاع الآن بحاجة أكثر من أي وقت مضى لإصلاحات قوية وحاسمة لتعزيز هذه المساهمة. لقد نجح المروجون لقطاع التمويل الإسلامي قبل 50 عاماً في وضع الركائز لقطاع جديد ونحن نعتقد بأن المسؤولية الآن تقع على عاتق جميع أصحاب المصلحة لضمان وصول هذا القطاع لأقصى إمكاناته.

نأمل بأن تنال نسخة "توقعات التمويل الإسلامي للعام 2021" إعجابكم، ونرحب دائماً بآرائكم وتعليقاتكم حول تحليلاتنا وأبحاثنا.





## Foreword

**Arif Amiri, Chief Executive Officer of DIFC Authority**

The last 12 months have seen developments in global Islamic finance industry, fueled by a dynamic Sukuk market and impactful investment in FinTech and innovation. The Middle East, Africa and South Asia (MEASA) region continues to be a significant contributor to an industry worth more than \$2.4 trillion, which grew 11.4% in 2019. DIFC is home to 46 active authorised firms who qualify as an Islamic financial institution and operate as an Islamic window. Most recently, we welcomed Malaysia's largest lender and the fifth largest sharia-compliant bank in the world, Maybank Islamic Berhad, to the Centre, bridging two of the leading global centres for Islamic finance.

Over the last year, DIFC recorded an increase in Islamic assets being managed in the Centre, along with 15% growth in value of Islamic contracts during the first quarter of 2020 when compared to the same period a year earlier.

Despite the strong start to 2020, the global pandemic is expected to have far-reaching implications for the financial sector as a whole, including Islamic Finance. Whilst we expect sector growth to slow, there is a clear opportunity for Islamic Finance to support countries, banks, companies and individuals impacted by the pandemic to navigate a path forward sustainably in line with Environment, Social and Governance (ESG) goals.

DIFC and Dubai Financial Market has launched the Dubai Sustainable Finance Working Group, uniting leading banks, financial institutions, as well as public and private companies. Focused on creating a sustainable financial hub in the region in line with the UAE Sustainable Development Goals 2030 and Dubai's Strategic Plan 2021, the group encourages the use of green financial instruments and responsible investing – principles which apply to Islamic Finance.

A key objective for 2020 was to create a framework to enable standardisation with the Islamic Finance sector. This is important to ensure sustained growth and longevity.

Like all sectors, innovation is critical. Embracing new technologies and business models are essential to maintain momentum within Islamic Finance. A sector goal is to 'leave no one behind' and FinTech disruption remains a key opportunity to service, support and attract new segments including the regional unbanked and underbanked. Millennial and Generation Z customers will continue to play a significant role in the growth of Islamic finance. They will expand the sector's future customer base, with the younger segment expected to contribute to as much as 75% of total bank revenue by 2030. We also recognise the importance of giving the next generation of Islamic Finance professionals the platform they need to embrace new technologies and bring solutions to life. DIFC has continued to invest time and resources into building the region's most comprehensive FinTech proposition. The Centre offers conducive and collaborative workspace, has introduced fit-for-purpose laws and regulations and nurtures early-stage start-ups through dedicated accelerator programmes. DIFC is a key hub for Islamic Finance institutions to engage with innovative start-ups. These include Dubai Islamic Economy Development Centre, Emirates Islamic Bank, Dubai Islamic Bank and Abu Dhabi Islamic Bank. As we continue on our journey towards shaping the future of finance, facilitating greater collaboration amongst our community and fostering innovation in the Islamic Finance industry will be central to supporting post pandemic recovery and delivering sustainable economic growth.

# Islamic Finance 2020-2021: COVID-19 Offers An Opportunity For Transformative Developments

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S&P Global Ratings believes the global Islamic finance industry will return to slow growth in 2020-2021 after strong performance in 2019 underpinned by a more dynamic sukuk market. The significant slowdown of core Islamic finance economies in 2020, because of measures implemented by various governments to contain the COVID-19 pandemic, and the expected mild recovery in 2021, explain our expectations.

## Key Takeaways

- We expect the Islamic finance industry to show low-to-mid-single-digit growth in 2020-2021 after 11.4% in 2019 following strong sukuk market performance.
- COVID-19 offers an opportunity for more integrated and transformative growth with a higher degree of standardization, stronger focus on the industry's social role, and meaningful adoption of financial technology (fintech).
- Coordination between different stakeholders is key to the industry leveraging these opportunities for sustainable growth.

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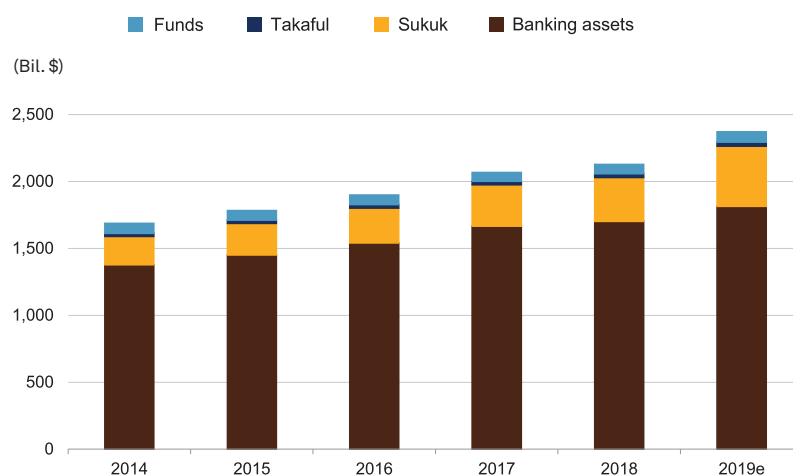


At the same time, we see an opportunity in the current environment for accelerating and unlocking the long term potential of the industry. Stakeholders are realizing the importance of standardization as government coffers are depleted and access to sukuk remains time consuming and more complicated than conventional instruments. Lockdown measures have also shown the importance of leveraging technology and creating a nimbler industry. Furthermore, industry players have been discussing the potential use of social instruments to help companies and individuals economically affected by the pandemic. With the right coordination between different Islamic finance stakeholders, we believe the industry could create new avenues of sustainable growth that serve the markets.

## Recession and Mild Recovery Thereafter Will Hold Growth Through 2020-2021

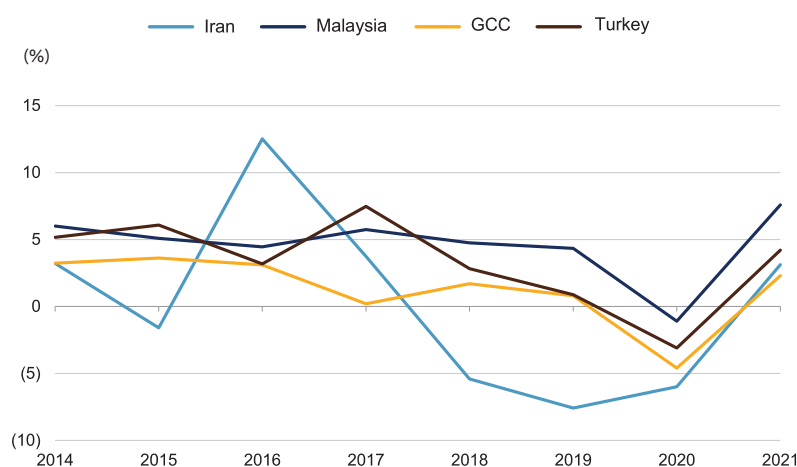
After strong performance in 2019 explained by higher-than-expected sukuk issuance, we believe Islamic finance industry growth will slow in 2020-2021 due to lockdown measures and ensuing recessions in Islamic finance core countries (see charts 1 and 2).

**Chart 1 - Islamic Finance Is A \$2.4 Trillion Industry That Will Stagnate In 2020-2021**



e--Estimate. Source: Central banks, Islamic Financial Service Board, Eikon, and S&P Global Ratings. Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

**Chart 2 - We Expect A Recession In Core Islamic Finance Markets In 2020 And A Mild Recovery In 2021**

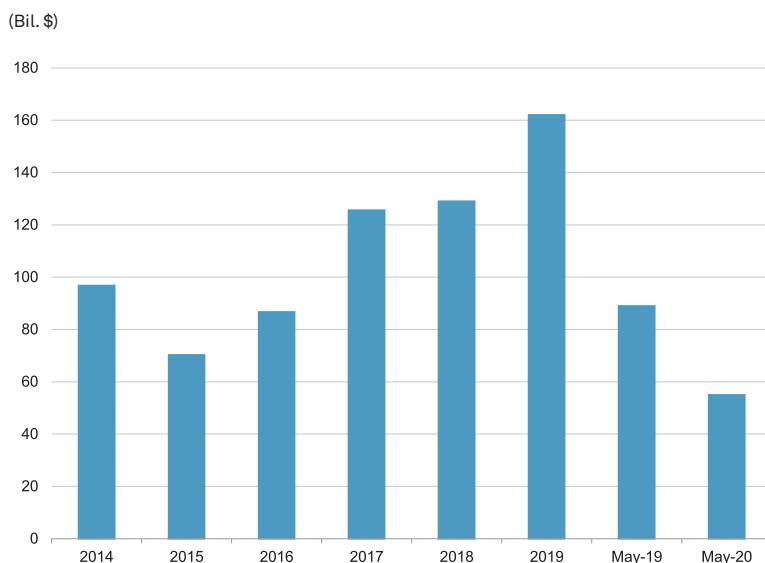


GCC--Gulf Cooperation Council. Source: S&P Global Ratings and IMF. Copyright © 2018 by Standard & Poor's Financial Services LLC. All rights reserved.

We expect Islamic banking to show at best stable total assets or low-single-digit growth. This follows 6.6% growth in 2019 thanks to good performance in the Gulf Cooperation Council (GCC), Malaysia, and to a lesser extent Turkey and Indonesia, but a declining contribution from Iran amid the deep recession reported by the IMF. In 2020, we expect a slowdown spurred primarily by measures implemented by various governments to control the COVID-19 pandemic. This slowdown will be somewhat counterbalanced by strong liquidity injections from various central banks to help their banking systems navigate the difficult environment. However, this, together with complexity and lower investor appetite, will contribute to a sukuk market slowdown in 2020. We project the volume of issuance will reach \$100 billion in 2020 compared with \$162 billion in 2019--when Turkey, returning GCC issuers, Malaysia, and Indonesia supported the market (see Chart 3).

The market was, in fact, poised for good performance in 2020 but the pandemic and lower oil prices changed the outlook. Amid tougher conditions, we also don't see core Islamic finance countries using sukuk as a primary source of funding despite their higher financing needs. However, we think that Turkey might try to tap the market aggressively in 2020 to use all of its available funding options. More broadly, we continue to see the takaful sector expanding at mid-single-to-high-digit rates, while the funds industry might see some negative effects from market volatility. Overall, we believe low-to-mid-single-digit growth for the overall industry is a fair assumption over the next two years. However, in our view, COVID-19 offers an opportunity for more integrated and multifaceted growth with higher standardization, stronger focus on the industry's social role, and greater use of fintech. This can be achieved through higher coordination between the industry's different stakeholders.

**Chart 3 – Sukuk Issuance Has Dropped And We Expect The Trend To Continue**



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## Social Islamic Finance Instruments Can Make A Difference

COVID-19 is causing a significant slowdown in core Islamic finance markets and a spike in unemployment. Although the predominantly migrant population structure in the Gulf and governments' support packages could absorb some of the shock, several stakeholders will lose a portion of their income. We think four Islamic finance social instruments in particular can help core Islamic countries, banks, and corporations navigate the current situation (see Related Research).

These are:

- Qard Hassan--This instrument could provide cost-free breathing space until the environment stabilizes. One example is when some GCC central banks opened free liquidity lines for financial institutions to provide subsidized lending to their corporate and small and midsize enterprise clients.
- Social sukuk--These instruments could help support the education and health care systems amid the current slump and attract environmental, social, and governance (ESG) investors (those investing for social reasons) and/or Islamic investors (those looking for Sharia-compliant investments).
- Waqf--This could help provide affordable housing solutions or access to health care and education for people that might have lost a portion of their income.
- Zakat--Based on our conversations with market participants, we believe that Zakat could help compensate for lost household income because of COVID-19.

These instruments, together with green sukuk--which are taking a back seat this year--and the additional layer of governance Islamic banks and instruments are subject to could help put the industry more prominently on ESG investors' radar.

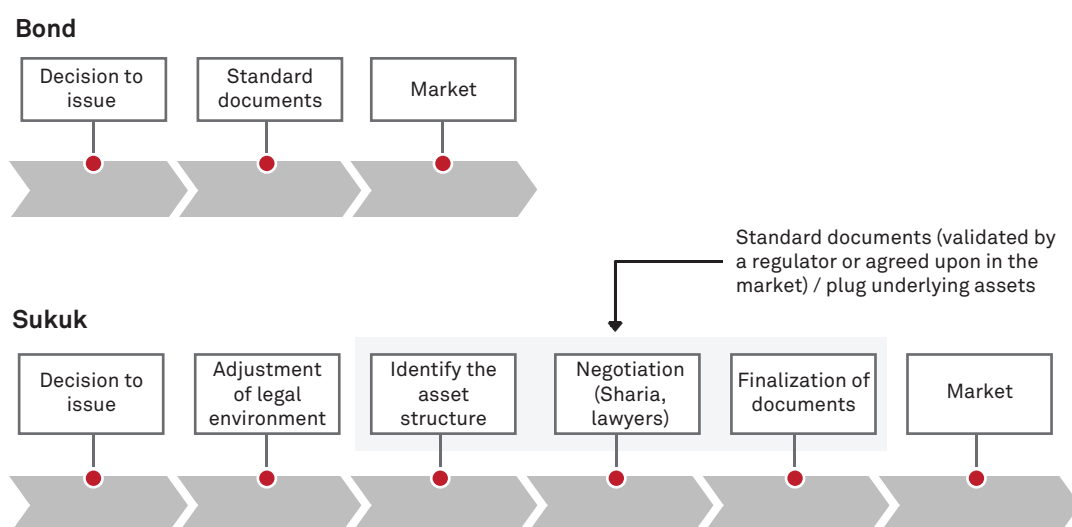


## Streamlining Sukuk Issuance Will Restore Its Attractiveness

Sukuk instruments remain more complex and time consuming for issuers compared with conventional bonds (see chart 4). As with previous crises, for example when oil prices crashed in 2014, the pandemic has shown that when core Islamic finance issuers need faster access to capital

markets they typically use conventional instruments. In the first five months of 2020, the total volume of sukuk issuance dropped 38% compared with the same period in 2019. Exceptions include issuers that have already established programs or can tap a recent issuance; issuers that are under stress and need to access all available funding sources; or issuers that are domiciled in jurisdictions where the sukuk process is streamlined.

**Chart 4 - Inclusive Standardization And Reduction Of Complexity**



Source: S&P Global Ratings.

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We acknowledge that the market has developed a certain way of doing transactions. However, a global set of standards that would be acceptable to all stakeholders is still lacking. 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 drive this agenda. More recently, the United Arab Emirates Ministry of Finance, the Islamic Development Bank, and the Dubai Islamic Economy Development Centre (DIEDC) established a partnership to develop an international legislative framework for Islamic finance, with the goal of accelerating growth and reducing discrepancies around the globe.

We view this as a step in the right direction as differences persist. For example, countries that adopted the AAOIFI standards might deem some sukuk structures commonly used in core Islamic finance countries noncompliant. This emphasizes the necessity for a critical review of some of the existing standards and the adoption of an inclusive approach taking on board the views of all stakeholders. The process would ultimately lead to standardization of the full spectrum of sukuk (from fixed-income-like instruments to equity-like) factoring the requirements of regulators, sukuk issuers, and investors. Standardization includes both aspects of sukuk: sharia interpretation and legal documentation. When sukuk issuance become comparable with conventional instruments from a cost and effort perspective they will find a more prominent place on issuers' and investors' books.

### Fintech Will Enhance The Industry's Resilience

Lockdown measures have demonstrated how the capacity of a company or a bank to shift its business online is critical for its continuity. For Islamic banks and sukuk, higher digitalization and fintech collaboration could help strengthen their resilience in a more volatile environment and open new avenues for growth.

However, recent months have demonstrated that there is still room for improvement. For example, because of the lack of financial inclusion and dedicated digital solutions, workers' remittances were delayed in some countries as exchange and money transfer outlets were closed. Sukuk structuring and issuance were also delayed because of a lack of fintech, despite the creation of a new platform where the issuance process is reportedly fairly streamlined. Last year, a new platform for sukuk issuance and management using data technology blockchain was launched. This platform, if adopted by the market, could boost GCC issuance volumes over time, since it significantly simplifies sukuk processes. It relies on a set of standardized legal documentation for sukuk structure. The issuer can just plug in its underlying assets and start building its investor book with a few clicks. The overall transaction is managed using blockchain, which helps improve transparency and traceability. This platform can also open the market to a new class of issuers that were until now excluded because of costs or complexity. More importantly, this shows that standardization of legal documents and Sharia rulings is actually achievable. Additionally, security of transactions and resisting cyberattacks while remaining in compliance with existing regulations has proven to be a prominent source of risk and could be remedied using regulatory technology.

A prerequisite for fintech enriching the Islamic finance industry is the provision of adequate physical infrastructure and implementation of the necessary supervision and regulatory framework. This is why several regulators/authorities in the GCC and elsewhere have launched incubators or specific regulatory sandboxes where fintech companies can test innovations.

### How Are Islamic Finance Ratings Affected?

In our view, fintech and social instruments will have a limited bearing on Islamic finance ratings in the next two years. So long as the use of social products or a more lenient approach to cost reduction is not significantly affecting banks' profitability, the impact on their creditworthiness would be limited. Similarly, we would not expect the social nature of a sukuk to affect the instrument's creditworthiness as long as we don't see any changes in the sponsor's financial obligations to pay sufficient amounts for the periodic distribution and principal reimbursement. We also forecast only a marginal influence from fintech 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. Moreover, although we think that blockchain could help the operational management of sukuk, we believe it will not induce any changes in the legal substance of transactions.

#### Related Research

- Islamic Finance And ESG: Sharia-Compliant Instruments Can Put The S In ESG, May 27, 2020
- How Resistant Are Gulf Banks To The COVID-19 Pandemic And Oil Price Shock?, April 22, 2020
- Credit FAQ: Will COVID-19 And Cheap Oil Reset The Market For GCC Tier 1 Instruments?, April 22, 2020
- Virus, Oil, And Volatility Will Put Sukuk Issuance Into Reverse, April 13, 2020
- GCC Banks Face An Earnings Shock From The Oil Price Drop And COVID-19 Pandemic, April 6, 2020
- AAOIFI's Proposal May Result In Different Interpretations On The Treatment Of Unrestricted Investment Accounts, Jan. 29, 2020

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



# Global Sukuk Market: A Window Of Opportunity Is Opening

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**S** &P Global Ratings believes that investors' risk aversion is subsiding, thanks among other factors to strong global liquidity. Over the past few weeks, issuers with good credit quality have approached the market, either by reopening sukuk or tapping established programs. Debut issuance remains rare. Despite this glimmer of optimism, total issuance volume for the full year 2020 will be lower than in 2019 since corporates are holding on to cash, cutting capital expenditure, and using bank financing.

**Key Takeaways**

- Conditions in financial markets are improving but not for all issuers.
- We expect global sukuk issuance to be muted this year since corporates are reducing capital expenditure and some sovereigns in core Islamic finance countries are tapping conventional markets.
- Yet we may see a surge in new sukuk targeting social needs as countries cope with the impact of the COVID-19 pandemic.

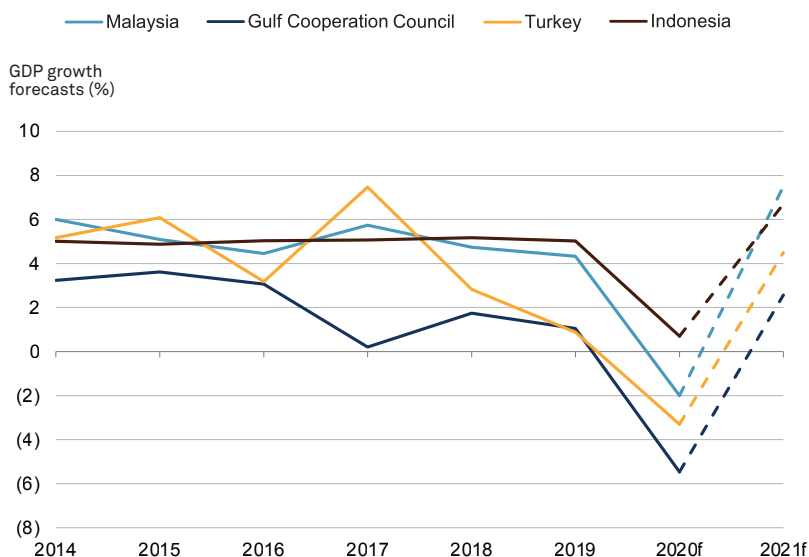
Central banks have already taken measures to boost banks' liquidity in core Islamic finance countries, so they are unlikely to issue sukuk as liquidity management instruments this year. They want banks' increased liquidity to reach corporates, thereby minimizing the risk of a long-lasting economic downturn resulting from COVID-19 and low oil prices. The difficult economic environment has led to higher financing needs for sovereigns, but most of them are turning to conventional markets due to the complexity of issuing sukuk.

Sukuk issuance volume fell 27% in the first six months of this year but we still expect it will total around \$100 billion for 2020, about 40% lower than in 2019. In the current environment, the number of defaults among sukuk issuers with low credit quality will likely increase, which will serve to test the robustness of legal documents for sukuk. Also, over the next six months, some sukuk may be issued to tackle social issues as economies recover, rather than solely to serve investors' financial interests. Such instruments will likely appeal to investors seeking to support the domestic economy or environment, social, and governance (ESG) goals.

## Sukuk Issuance Will Stay Low Until Economies Recover

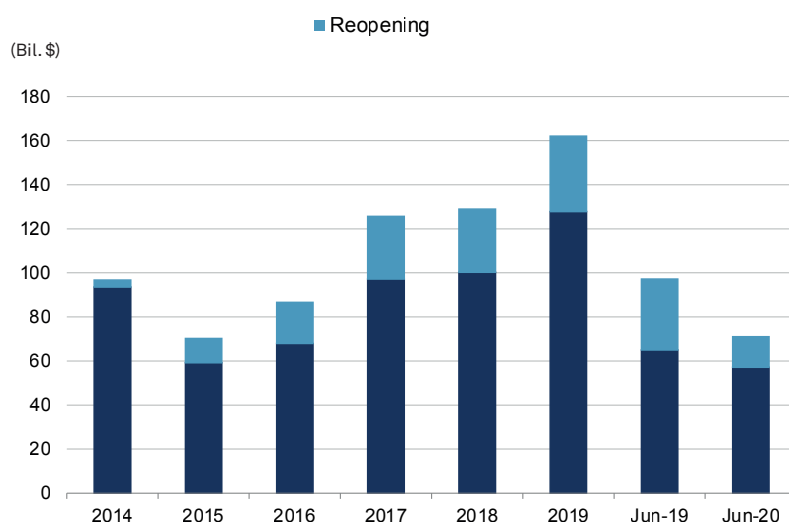
As the spread of the coronavirus moderates in many core Islamic finance countries, policymakers will prioritize restarting the economy and limiting the overall impact of containment measures on productive capacity and employment. Yet the events of 2020 will still constitute a major economic shock for all core Islamic finance countries, with a significant reduction of economic growth before a mild recovery in 2021 (see chart 1). Against this backdrop, the volume of sukuk issuance will remain depressed in our view (see chart 2). In the first six months of 2020, the market dropped by 27%. We expect issuance volume to reach \$100 billion at best this year compared with \$162 billion in 2019, which represents an almost 40% decline.

**Chart 1 - Core Islamic Finance Countries Will Experience A Major Economic Slowdown**



f--Forecast. Source: S&P Global Ratings  
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**Chart 2 - Sukuk Issuance Volume Will Remain Depressed**



Source: S&P Global Ratings, Eikon.  
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## Fresh Liquidity Has Reduced Issuance Needs

In response to low oil prices and the pandemic's impact on the economy, several central banks launched liquidity programs to help corporations cope and to preserve the productive capacity of their economies. As such, local banks are able to meet most of the economies' financing needs. We expect bank lending to increase by low- to mid-single digits in most core Islamic finance countries in 2020, and for some loans to be at subsidized rates; so there's little incentive for corporates to issue sukuk. On top of this, corporates' financing needs have reduced, since they are delaying investments and reducing capital expenditure in the uncertain environment. Central banks have also reduced their issuances. So far in 2020, they have been injecting liquidity into the banking systems rather than taking it out; but we foresee some opportunistic issuances in 2020.

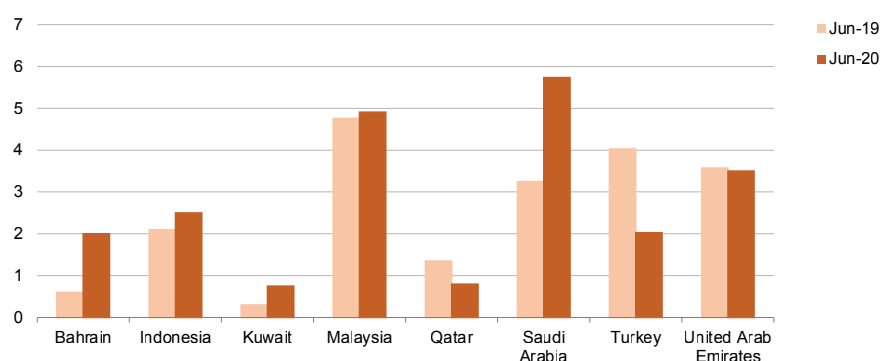
## Investors' Risk Appetite Is Slowly Increasing

Market conditions have been extremely volatile over the past few months because of the pandemic. However, news of several countries' success in containing the virus and the gradual lifting of restrictions brought some stability to global capital markets, and we've seen an uptick in issuance (see chart 3). For example, the Indonesian government issued a \$2.5 billion global sukuk in June 2020, including a \$750 million "green" tranche. One of the tranches with a 30-year maturity was well received by investors based on its pricing. The overall sukuk offering was heavily oversubscribed, showing that, even during episodes of volatility, issuers with a sound credit standing can retain access to the market.

The volume of foreign-currency-denominated issuance has increased by 11.3%, primarily due to higher issuance from the Islamic Development Bank as part of its planned increase in lending, and a Kuwaiti bank's opportunistic launch of a Tier 1 instrument before the capital market instability started. Bahrain has also stepped up its foreign currency issuances to support liquidity, and appears to favor sukuk as an instrument to raise funds. In our view, this will continue, unless there are setbacks, for instance due to a major second wave of infections.

**Chart 3 - Sukuk Issuance In Foreign Currency Has Increased**

(Bil. \$)



Source: S&P Global Ratings, Eikon.

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Some market observers have wondered why governments in the Gulf and other core Islamic finance markets rushed to conventional capital markets instead of issuing sukuk. The answer is simple: Sukuk issuance is still more complex than for conventional bonds. Only when the processing of both instrument types become broadly comparable--from a time, cost, and offer perspective--would governments view sukuk as an efficient source of funding on a regular basis. The adoption of standards could help achieve this end if it happens across all markets, and if standard setters use a more inclusive approach in designing issuance standards. We are not yet there.

One positive development is that the Dubai Islamic Economy Development Center has recently announced it will work with partners to come up with an international legal framework for Islamic finance. This is a positive step, but certain matters remain to be clarified, such as the scope and duration of the project and the willingness of Islamic finance jurisdictions to participate.

### More Defaults And Innovation Will Come

Given the current shocks to the economic environment, credit risk is rising. We might see much higher default rates among sukuk issuers, especially those with low credit quality or business plans that depend on supportive economies and market conditions. Defaults will test the robustness of the legal documentation used for sukuk issuance and provide insight into the outcome for investors. Investors generally do not have access to the sukuk's underlying assets in the event of a default, except when those assets were sold to the special purpose vehicle issuing the sukuk, which is an exception rather than the norm. We expect defaults and the implications for investors will bring the debate on standardization of legal documents back to the forefront.

The other interesting trend we've observed is the use of innovative structures to finance the economic recovery. One of them is the \$1.5 billion sustainability sukuk issued by multilateral institution, the Islamic Development Bank (IsDB). The proceeds of this sukuk will reportedly go toward helping the IsDB's member countries cope with the impact of the pandemic, particularly on health care and small and midsize enterprises. Another example is the Prihatin sukuk that Malaysia is putting together. According to some market sources, the closest conventional instrument to this sukuk would be a war bond. The idea is to issue a zero periodic-distribution-rate sukuk and use the proceeds to help restart the economy. The instrument will not only be attractive to investors from a financial standpoint but also to local investors (including retail investors) keen to contribute to the economic recovery. It may also appeal

to other local or foreign investors with ESG objectives. We understand the proceeds of the sukuk will support microenterprises run by women, improve broadband internet coverage for schools in rural areas, and provide research grants for the treatment of infectious diseases.

If anything, this shows that the pandemic is opening up a channel to put the 'S' of ESG back into Islamic finance and show the social aspect built into the core Sharia goals (Maqasid). We also think we will see more of these instruments, not just in Malaysia but elsewhere.

Although a part of sustainable finance, green sukuk will likely remain on the sidelines while governments in core Islamic finance countries deal with the impact of the pandemic. If green sukuk can help accelerate the economic recovery, for example, by furthering efforts toward the energy transition, then we may see a resurgence in issuance. We don't expect that to happen over the next two quarters, however, but more likely in 2021.

### Related Research

- Islamic Finance 2020-2021: COVID-19 Offers An Opportunity For Transformative Developments, June 15, 2020
- Islamic Finance And ESG: Sharia-Compliant Instruments Can Put The S In ESG, May 27, 2020
- Credit FAQ: Will COVID-19 And Cheap Oil Reset The Market For GCC Tier 1 Instruments?, April 22, 2020
- How Resistant Are Gulf Banks To The COVID-19 Pandemic And Oil Price Shock?, April 22, 2020
- Virus, Oil, And Volatility Will Put Sukuk Issuance Into Reverse, April 13, 2020
- AAOIFI's Proposal May Result In Different Interpretations On The Treatment Of Unrestricted Investment Accounts, Jan. 29, 2020
- Sukuk Market To Continue Expanding In 2020, Barring Event Risk, Jan. 12, 2020

*This report does not constitute a rating action.*



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## Profile

Proposed U.S. dollar-denominated sukuk trust certificates assigned preliminary 'B' rating.

## Transaction Overview

This presale report is based on information dated Dec. 17, 2019, and is posted in conjunction with the planned U.S. dollar-denominated sukuk trust certificates by **GFH Sukuk Company Ltd.** (GFH Sukuk), a special-purpose vehicle (SPV) incorporated with limited liability in the Cayman Islands.

Under the sukuk documents, the SPV will use the proceeds from the sale of trust certificates to:

- Purchase, for no less than 51% of the face value of sukuk certificates, certain real estate assets or transfer of certain securities interest from GFH or its subsidiaries (Wakala assets). These assets will then be leased to GFH as lessee under the lease agreement; and
- Purchase for no more than 49% of the face value of sukuk certificates commodities, which will then be sold on a deferred sale basis to GFH under the murabaha contract.

## Rationale

The rating on the trust certificates reflects the rating on GFH because the transaction fulfils our conditions for rating sukuk at the same level as the rating on its sponsor (see "General Criteria: Methodology For Rating Sukuk," published Jan. 19, 2015, on RatingsDirect):

- GFH will provide sufficient and timely contractual obligations to pay the principal and the periodic distribution amounts. The latter will be covered by the rental under the lease agreement and by profit amount under Murabaha. Principal will be covered by the exercise price under the purchase undertaking agreement and deferred sale price under the murabaha contract.
- The company's obligations under the murabaha and lease contracts are irrevocable.
- These obligations will rank pari passu with GFH's other senior unsecured financial obligations.
- GFH will undertake to cover all the costs related to the transaction, through the additional supplementary rent under the leasing and the service agency agreements.

- We view the total loss event (TLE) as remote. We base this on our understanding that the portfolio of underlying real estate assets is diversified.

We therefore equalize the rating on the sukuk with the long-term issuer credit rating on GFH. The rating on the sukuk transaction is based on draft documentation dated Dec. 17, 2019. Should final documentation differ substantially from the draft version, we could change the rating on the sukuk.

### **A sukuk structure that provides sufficient contractual obligations for full and timely repayment**

The transaction involves GFH Sukuk, an SPV incorporated in Cayman Islands, for issuing trust certificates.

Under the sukuk documents, the SPV will use the proceeds from the sale of trust certificates to:

- Purchase, for no less than 51% of the face value of sukuk certificates, certain real estate assets or transfer of certain securities interest from GFH or its subsidiaries (Wakala assets). These assets will then be leased to GFH as lessee under the lease agreement; and
- Purchase for no more than 49% of the face value of sukuk certificates commodities, which will then be sold on a deferred sale basis to GFH under the murabaha contract.

Under the lease agreement, GFH will pay rentals, which will be calculated as the rental rate times the total face amount of the certificates and days' count fraction less total profit amounts payable pursuant to the murabaha agreement. GFH will also pay the profit amount under the murabaha agreement. In our preliminary rating, we assume that the periodic payable rental is calibrated to match the periodic distribution amount. If this is not the case, we might assign a different rating to the transaction.

When the transaction matures or upon the occurrence of an early dissolution event:

- GFH will pay the deferred sale price and any accrued profit amount under the murabaha agreement; or
- GFH will purchase the Wakala assets for the exercise price, which will equal the total face amount of certificates outstanding, all accrued but unpaid periodic distributions, and any other amounts payable less deferred sale price under the murabaha agreement.

GFH's obligations under the lease and the murabaha agreements are irrevocable and unconditional, and will rank equally with its other senior unsecured financial obligations.

### **Total Loss Event**

While the documentation includes a TLE, we view as remote the risk that a TLE would occur and jeopardize the sukuk's full and timely repayment. This view is predicated on our expectations that the portfolio of the underlying assets will be diversified between various properties located in Bahrain.

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.

## Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- Criteria | Financial Institutions | Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- General Criteria: Methodology For Rating Sukuk, Jan. 19, 2015
- Criteria | Financial Institutions | Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Related Research

- Bahrain-Based GFH Financial Group Rated 'B'; Outlook Stable, Dec. 24, 2019

# Presale: Axiata SPV2 Bhd.

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## Profile

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

## Transaction Summary

This presale report is based on information dated Aug. 11, 2020, and is posted in conjunction with the planned issuance of U.S. dollar-denominated sukuk (trust certificates) by Axiata SPV2 Bhd., a special-purpose vehicle (SPV) incorporated in Malaysia. The proposed issuance is out of an existing US\$1.5 billion multi-currency sukuk issuance program set up in 2012.

Under the sukuk program documentation, Axiata SPV2 Bhd. (issuer, trustee) will enter into, among other contracts:

- A combination of the following with Axiata: (i) a "Master Murabaha Agreement" where the SPV may purchase and sell commodities to Axiata Group Bhd. (Axiata) with up to 48% of the issue proceeds; (ii) a "Master Airtime Purchase Agreement" and a "Supplemental Airtime Purchase Agreement" where the SPV may purchase all of Axiata's interest, rights, benefits, and entitlement in and to identified airtime vouchers; (iii) a "Master Share Purchase Agreement" and a "Supplemental Share Purchase Agreement" where the SPV may purchase Axiata's beneficial ownership of

identified shares and (iv) a "Master Headlease Agreement" and a "Supplemental Headlease Agreement" where the SPV may lease from Axiata identified lease assets. For this particular proposed issuance series, 100% of the issuance proceeds will go toward purchase of airtime vouchers from Axiata.

- A "Master Wakala Agreement" with Axiata, which acts as the Wakeel.
- A purchase undertaking granted by Axiata in favor of Axiata SPV2 Bhd.

We understand that the proceeds from the proposed sukuk issuance will be used to refinance existing debt, which, in turn, will fund general corporate purposes in accordance with the Sharia principle.

## Rationale

The preliminary rating on the proposed drawdown reflects the issuer credit rating on Axiata, 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). Specifically, Axiata will enter into a supplemental airtime purchase agreement with Axiata SPV2 and purchase airtime vouchers for the total nominal amount of the sukuk. In addition, under the program terms and conditions:



- Axiata will provide sufficient and timely contractual obligations for the payment of the periodic distribution amounts (via the Master Wakala Agreement) and the principal amount (via the purchase undertaking).
- These obligations rank pari passu with Axiata's other senior unsecured financial obligations.
- Axiata's obligations under the sukuk issuance are irrevocable.
- Axiata will undertake to cover all the costs related to the transaction through the Master Wakala Agreement.
- The documentation mentions a risk of a revocation event. This would refer to the case where the provider of the airtime vouchers lost its license to provide telecommunication services. Under the assumption that the revoked assets are not replaced within 45 days, such scenario will trigger the early dissolution of the sukuk and the unconditional obligations for Axiata to pay, among other obligations, the outstanding face amount of the sukuk and all accrued and unpaid profits.

We therefore equalize the rating on the proposed sukuk issuance with the long-term issuer credit rating on Axiata. The preliminary rating on the proposed sukuk transaction is based on draft documentation dated Aug. 11, 2020.

**Table 1 - Axiata SPV2 Bhd.--Transaction Details**

Issuer, trustee, buyer of airtime vouchers	Axiata SPV2 Bhd.
Obligor, wakeel, and seller of airtime vouchers	Axiata Group Bhd.
Arrangers	Citigroup Global Markets Singapore Pte. Ltd., CIMB Investment Bank Berhad, Standard Chartered Bank and UBS AG Singapore Branch
Principal paying agent	The Hong Kong Shanghai Banking Corp. Ltd.
Delegate	The Hong Kong Shanghai Banking Corp. Ltd.
Governing law	English law

## Sukuk structure provides sufficient contractual obligations for full and timely repayment.

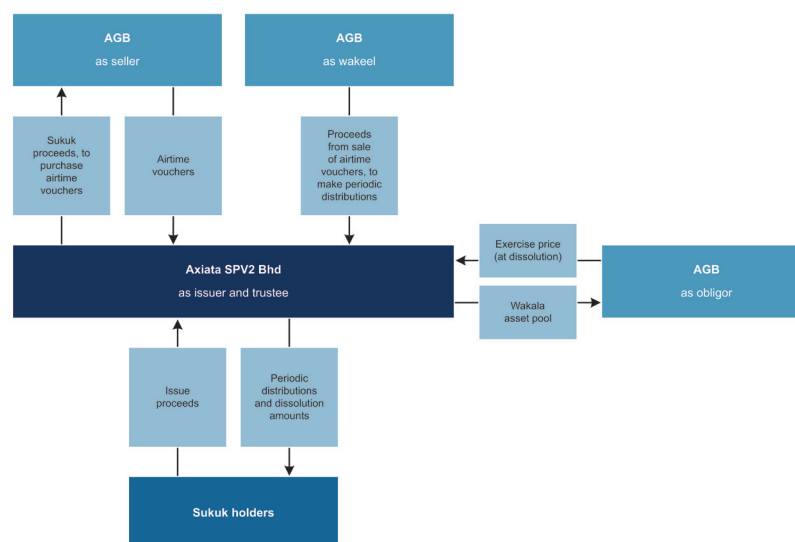
The proposed transaction involves Axiata SPV2 Bhd., an SPV incorporated in Malaysia, for issuing trust certificates.

Specific to this proposed issuance, 100% of the proceeds will be used to purchase airtime vouchers from Celcom Axiata Bhd., a 100% subsidiary of Axiata.

Under the Wakala agreement, Axiata will pay the proceeds of the sale of airtime vouchers to a transaction account. We understand that the quantity and the minimum sale price are calibrated to match the periodic distribution amounts. If there is a shortfall between the sale proceeds and the periodic distribution amounts, this will trigger an obligation on Axiata to indemnify the issuer for a sufficient amount for the payment of the periodic distribution amount. This obligation is irrevocable and will rank pari passu with Axiata's other unsecured and unsubordinated obligations.

At the maturity date of the transaction or upon the occurrence of an early dissolution event, Axiata will purchase the SPV's interest, rights, benefits, and entitlements in and to the airtime vouchers at the sukuk exercise price, which comprises the outstanding face amount of the sukuk for the series, all accrued but unpaid distribution profit relating to the airtime vouchers, and other amounts payable.

Chart 1 - Brief Overview Of The Sukuk Agreements



AGB--Axiata Group Bhd

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All of Axiata's obligations under the proposed sukuk issuance are irrevocable, unconditional, and will rank pari passu with its all other outstanding unsecured and unsubordinated obligations.

## Total loss event

The documentation mentions a risk of a revocation event. This would refer to the case where the provider of the airtime vouchers lost its license to provide telecommunication services. Under the assumption that the revoked assets are not replaced within 45 days, such scenario will trigger the early dissolution of the sukuk and the unconditional obligations for Axiata to pay, among other obligations, the outstanding face amount of the sukuk and all accrued and unpaid profits. This obligation is irrevocable, unconditional, and will rank pari passu with Axiata's all other outstanding unsecured and unsubordinated obligations.

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.

## Issue Ratings--Subordination Risk Analysis

### Capital structure

As of March 31, 2020, Axiata's capital structure consisted of Malaysian ringgit (MYR) 17.9 billion of debt. We estimate that about MYR10.7 billion of debt is held by operating subsidiaries, of which MYR591 million is secured.

### Analytical conclusions

We equalize the issue ratings on Axiata's outstanding senior unsecured notes, and existing and proposed sukuk with our 'BBB+' issuer credit rating on the company, despite the high priority debt of 60%. This reflects our view that Axiata's geographical diversification--with more than three subsidiaries each generating more than 10% of EBITDA--could mitigate subordination risk.

## Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- 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: 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: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

# Islamic Finance And ESG: Sharia-Compliant Instruments Can Put The S In ESG

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As regulators and policymakers around the world seek to establish a more sustainable, stakeholder-focused, and socially responsible financial system for the future, S&P Global Ratings notes there are certain similarities between Islamic finance and sustainable finance. Islamic finance abides by the goals and objectives of Sharia, and has some overlap with environmental, social, and governance (ESG) considerations and the broader aim of sustainable finance. Although this may sound obvious for environmental aspects through green sukuk and governance aspects through the presence of additional governance layers, the social aspect has until now been less obvious.

## Key Takeaways

- COVID-19 has significantly slowed core Islamic finance economies because of their governments' measures to combat the spread of the virus.
- Unemployment rates will rise as some companies see significant revenue reduction.
- Islamic finance provides socially responsible products, and the current environment could offer the possibility to leverage them.



The spread of COVID-19 and countermeasures to slow its spread have significantly slowed the core Islamic finance economies. As a result, we expect unemployment rates to increase, with a consequent significant loss of income for households as companies implement measures to reduce their costs amid declining revenue. The Islamic-finance industry has been talking about the potential to use the social instruments of Islamic finance to help address the impact of COVID-19 on corporates and banks through unremunerated or subsidized liquidity to help them cope with the short-term loss in revenue and allow them to preserve employment.

Social instruments could also be used directly to support households by compensating them for lost income, and by providing access to affordable basic services, such as education and health care. From a credit rating perspective, in our opinion, banks' use of social instruments would have a limited effect on their balance sheets, as long as such instruments did not significantly reduce their profitability or increase their costs materially. The social nature of sukuk would have no bearing on the instrument's creditworthiness as long as the social measures did not change the sponsor's obligation to pay sufficient amounts for the periodic distribution and principal reimbursement.

## COVID-19 is causing a major slowdown in core Islamic finance markets and a spike in unemployment

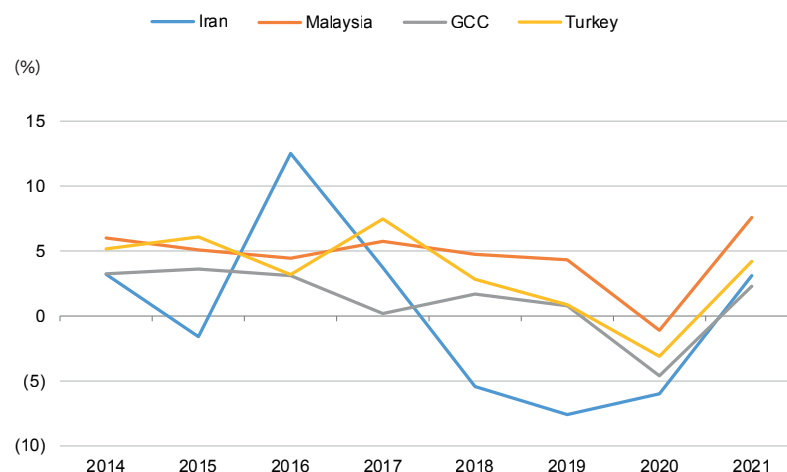
Over the past three months, data show that the measures designed to curb the spread of COVID-19 are having a negative economic impact and worsening the business and financial positions of core Islamic finance countries.

- Service sectors will be hit harder than manufacturing sectors;
- Discretionary consumer spending will be hit harder than spending on necessities; and
- Smaller businesses will be hit harder than larger ones.

In particular, lockdowns and social distancing constraints are damaging countries' economies and we think that certain core Islamic finance countries will be hit hard in 2020 (see chart 1).

**Chart 1 - A Strong Economic Shock**

Real GDP growth rate



GCC--Gulf Cooperation Council. Source: S&P Global Ratings; IMF.  
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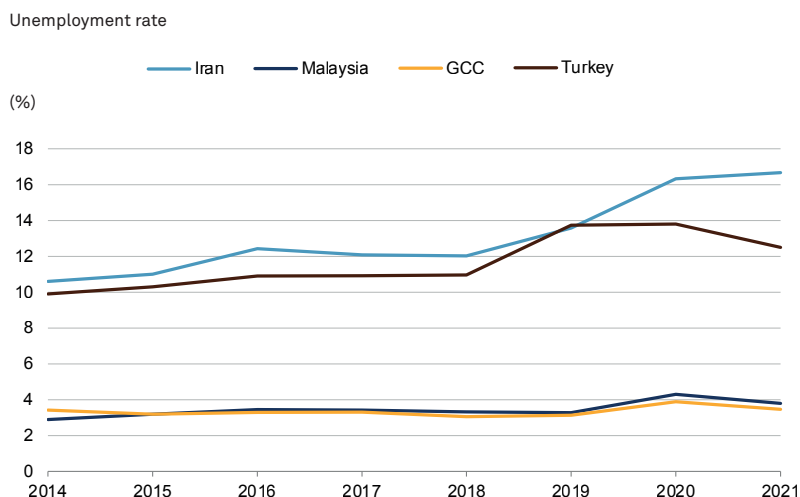
The economies of these countries are either dependent on commodities or on services. They are also less industrialized than countries in more developed markets and have smaller corporate sectors typically dominated by small and midsize enterprises (SMEs). We think it likely that unemployment rates and household loss of income will rise in some of these countries (see chart 2).

The fact that foreign workers represent the majority of the working population should somewhat offset the increase in unemployment in the Gulf Cooperation Council (GCC), because many foreigners will likely return to their home countries if they are furloughed or laid off. In addition, government intervention through various support measures should somewhat counterbalance the negative effects of higher unemployment. For example, some GCC governments announced they would cover the private sector salaries of their nationals--and in some of the countries the salaries of foreign workers as well. Such measures will result in additional government spending needing to be financed, especially at a time when oil receipts for commodities-exporting countries and tax receipts for other countries are declining (see chart 3).

### Islamic finance social instruments could help countries navigate the economic turbulence wrought by the pandemic

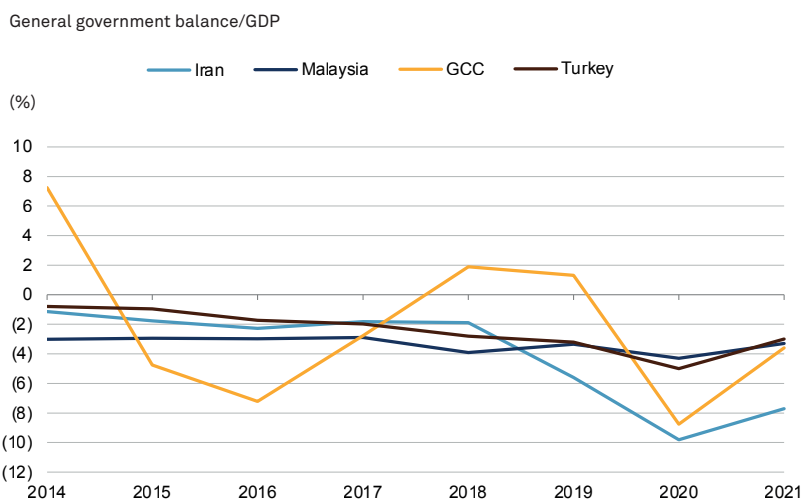
Islamic finance abides by the goals and objectives of Sharia (Maqasid). While interpretations of the Maqasid differ, they broadly center around the protection of faith, life, mind, wealth, and dignity. Until now, in the context of ESG, the social aspects of Islamic finance appear to have been somewhat secondary to the wider climate change and environmental concerns.

**Chart 2 -Unemployment Will Be Pushed Higher**



GCC--Gulf Cooperation Council. Source: S&P Global Ratings; IMF.  
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**Chart 3 - Financing Needs Are Increasing**



GCC--Gulf Cooperation Council. Source: S&P Global Ratings; IMF.  
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**We think four Islamic finance social instruments in particular can help core Islamic countries, banks, and corporations navigate the current situation:**

**Qard Hassan.** This instrument consists of a loan granted for welfare purposes or to bridge short-term funding requirements where the borrower is required to repay only the principal. As corporations and individuals grapple with the impact of COVID-19 on their revenue, Qard Hassan from banks could provide breathing space until the environment stabilizes. For example, the central banks of some GCC countries opened liquidity lines for financial institutions at no cost to provide subsidized lending to their corporate and SME clients.

**Social sukuk.** These are sukuk, where the rate of return declines if the issuer fulfills certain social objectives. Sukuk Ihsan, issued by Khazanah National Berhad in 2015-2017, are an example of such instruments. These instruments could help support the education and health care systems amid the current crisis and attract particularly ESG investors (those looking to invest for social reasons) and/or Islamic investors (looking for Sharia-compliant investments).

**Waqf.** This consists of a donation of an asset or cash for religious or charitable purposes with no intention of repayment or remuneration. Waqf in the current circumstances could help provide affordable housing solutions or access to health care and education for people that might have lost a portion of their income. Recently, a U.N. agency signed an agreement with the Islamic Corporation for the Development of the Private Sector to look at the potential use of Waqfs as a source of sustainable financing focusing on vulnerable Saudi communities. The Accounting and Auditing Organization for Islamic Financial Institutions prepared an exposure draft on Waqf governance, but it has not yet been approved.

**Zakat.** This is similar to a tax levied on wealth over a certain threshold. Zakat can be used for social welfare purposes, for example supporting people in need or that have lost a portion of their income, without any expectations of repayment or remuneration. Based on our conversations with market participants, we believe that Zakat could help compensate the loss of income for households because of COVID-19.

In addition to these instruments, we also understand that Islamic banks are considering a more lenient approach concerning their potential headcount reduction, unless the crisis deepens further. Several conventional banks have already announced that they will retain staff for the time being, but also use other measures, such as paid leave with or without a reduced salary or remote working arrangements. Stakeholders in Islamic banks could perceive major layoffs negatively and such moves would probably also find some opposition from their governance structures, including Sharia boards.

From a credit rating perspective, as long as the use of social products or a more lenient approach for cost reduction doesn't have a significant impact on banks' profitability, the impact on their creditworthiness would be limited. Similarly, we would not expect the social nature of a sukuk to have any impact on the instrument's creditworthiness as long as we don't see any changes in the sponsor's financial obligations to pay sufficient amounts for the periodic distribution and principal reimbursement.

S&P Global Ratings acknowledges a high degree of uncertainty about the rate of spread and peak of the coronavirus outbreak. Some government authorities estimate the pandemic will peak about midyear, and we are using this assumption in assessing the economic and credit implications. We believe the measures adopted to contain COVID-19 have pushed the global economy into recession (see our macroeconomic and credit updates here: [www.spglobal.com/ratings](http://www.spglobal.com/ratings)). As the situation evolves, we will update our assumptions and estimates accordingly.

## Related Research

- The ESG Lens On COVID-19, Part 2: How Companies Deal With Disruption, April 28 2020
- The ESG Lens On COVID-19, Part 1, April 20, 2020
- COVID-19: A Test Of The Stakeholder Approach, April 21 2020
- ESG Evaluations Remain Unchanged For Now In Light Of COVID-19, April 8, 2020
- Environmental, Social, And Governance: ESG Credit Factors In Structured Finance, Sept. 19, 2019
- The Role Of Environmental, Social, And Governance Credit Factors In Our Ratings Analysis, Sept. 12, 2019
- Environmental, Social, And Governance: Islamic Finance And ESG: The Missing 'S', May 20, 2019

*This report does not constitute a rating action.*

# Prolonged COVID-19 Disruption Could Expose The GCC's Weaker Borrowers

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(Editor's note: This report revises our views on the economic impact of the widening COVID-19 epidemic. It follows our Feb. 16, 2020, report "Coronavirus Increases Risks For Gulf Economies".)

## Key Takeaways

- COVID-19 will weigh on the economies of the Gulf Cooperation Council (GCC) region as weakening global demand drags down oil prices and hampers important industries such as tourism and real estate.
- As global financing conditions deteriorate, funding costs for more-leveraged borrowers are rising and investor appetite for less-creditworthy issuers could fade.
- The high level of uncertainty regarding the duration and eventual severity of the crisis will increase downside risks.

## What Has Changed?

The COVID-19 epidemic has broken through China's containment. Confirmed cases of the disease are spiking in South Korea, Italy, and Iran, and it has spread to more than 100 countries. Aside from the human toll, the increasing economic implications are casting a darker shadow over the global growth outlook, which has direct implications for the GCC.

Regional markets have been hit by travel and human-movement restrictions imposed by governments, and consumer and business responses. The outbreak is no longer just an issue for China and its closest economic partners, nor just restricted to the supply chain. Both supply and demand effects are in play, and being amplified by tightening financial conditions, which significantly complicates any impact analysis.



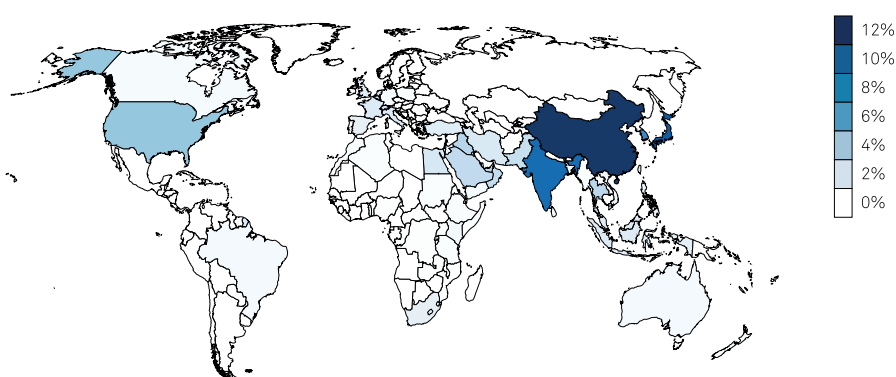
## Our 2020 Oil Price Assumptions Fall To \$40 Per Barrel From \$60

Weaker global demand will strain GCC economies, and the effect will be amplified by key trading partner concentrations. Since our previous publication, we have revised down our assumptions on global growth to 2.8%

from 3.3%. In commodities, we now expect oil prices to fall in 2020. The GCC region's goods exports are almost entirely hydrocarbon-related. Worse still, just four countries--China, South Korea, Japan, and India--buy about 40% of the region's exports (see chart 1). This leaves the GCC vulnerable to more-severe disruption in those markets.

### Chart 1 - GCC Goods Exports By Destination

Percent of total exports



Source: S&P Global Ratings.  
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We now expect China's growth to be 90 basis points lower in 2020 than we forecast at year-end 2019 (see Related Research). Consumption is likely to weaken, as consumer confidence wanes and authorities restrict activity. Consequently, we think GCC countries' economies will be impacted.

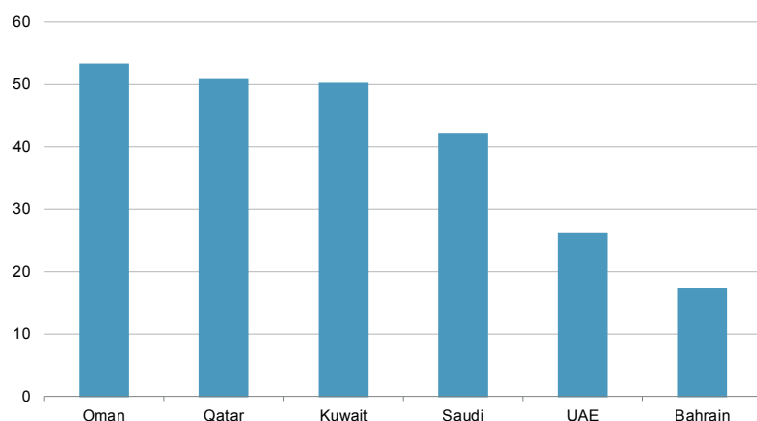
Exports to countries with a high or currently spiking number of cases--China, South Korea, Japan, Italy, France, Germany, Spain, and Iran--are at risk. We estimate that the volume of vulnerable goods exports ranges from 53% of total exports for Oman to about 17% for Bahrain (see chart 2). As the volume of exports falls, the region's external and fiscal balances will suffer. At OPEC meetings late last week, oil producers failed to agree to further production cuts in response to expected significant reductions in global demand. Russia's refusal to agree to an additional 1.5 million barrels per day (mmbbls/d) of cuts on top of the

existing 2.1 mmbbls/d set to expire on March 31 prompted a strong response. Following the meetings, Saudi Arabia surprisingly announced it was immediately slashing its official selling price and would increase its production above 10 mmbbls/d after the existing cuts expire. The kingdom cut April prices for all crude grades by \$6 per barrel (/bbl)-\$8/bbl. These actions possibly signal that Russia and OPEC have engaged in a price war with the intention of maintaining market share and relevance, despite a collapse in global demand. It is currently unclear how high Saudi production will go and for how long, but it is believed that the kingdom can produce approximately 12 mmbbls/d. There remains the possibility that Russia and Saudi Arabia could re-engage in discussions. However, given the apparent confrontational rhetoric and failure to reach an agreement, we don't expect this to occur within the next few months.

**Chart 2 - GCC Exports To High Risk Countries**

2018 data

% of goods exports\*



High risk countries--Defined as countries where Covid-19 cases are the highest according to the World Health Organization (China, Republic of Korea, Japan, Italy, France, Germany, Spain, and Iran). \*Goods exports accounted for 80% of the GCC's combined total current account receipts.

Source: National Sources and S&P Global Ratings.

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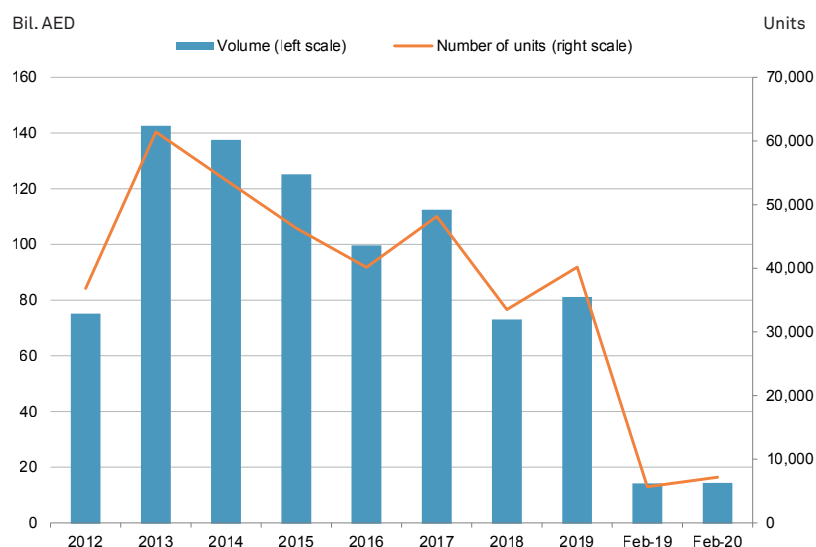
hefty economic hit in 2020 if the pilgrimage season, which starts in July, or Dubai's hosting of the 2020 World Expo (Expo 2020), which starts in October, are affected. Saudi Arabia received 23.6 million tourists in 2018, with a large portion visiting for religious reasons. In the UAE, Dubai received 16.7 million tourists in 2019 and the tourism sector contributed 11.5% of GDP at year end. Expo 2020 was expected to receive 25 million visitors in just six months. Officials anticipated that more than 70% would come from outside the UAE.

If the coronavirus is not contained, visitor numbers will be lower than expected. However, despite this potential disruption and the uncertain recovery path, we do not expect all activity to be lost. Instead, it could be postponed--visits and events in the region could be rescheduled to later dates. For the UAE, the real estate sector is also an important consideration. The sector has been under increasing strain for the past three years, and the spread of COVID-19 is exacerbating the situation. Over the first two months of 2020, the volume of real estate transactions in Dubai proved relatively resilient. The Real Estate Regulatory Authority reported that sales totaled UAE dirham (AED) 14.0 billion, up from AED13.9 billion during the same period in 2019 (see chart 3).

## Travel, Tourism, And Consumer Spending Will Decline

The GCC's hospitality industry, which includes sectors like airlines, hotels, and retail, will see lower revenue because of decreased tourism and business flows, as travel aversion and restrictions bite during the peak tourism season. These factors will also reduce transit and outbound travel by visitors and residents respectively. Several GCC states have suspended their travel connections with countries where virus cases are high or currently spiking. For example, Saudi Arabia banned foreign nationals from visiting the holy city of Mecca until March 31. In the United Arab Emirates (UAE), the Ministry of Foreign Affairs issued a ban on travel to Thailand and Iran for UAE citizens and connections with certain countries/cities were suspended. Furthermore, Qatar has reportedly imposed entrance restrictions on visitors from several countries.

We have yet to see whether COVID-19 will dent the number of pilgrims traveling to Saudi Arabia. Both the kingdom and neighboring UAE would take a

**Chart 3 - Dubai Real Estate Sales**

AED--UAE-dirham. Source: S&P Global Ratings.

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We expect sales volumes to decline or, at best, stabilize across the whole of 2020 because of lower demand, offset in part by cheaper mortgages. For Qatar and Saudi Arabia, we anticipate that lower economic growth will intensify the downward pressure on real estate prices. In Kuwait, the recovery we had previously expected for residential real estate prices might be delayed.

### For Low-Rated Issuers, Market Access Is Likely To Be Curtailed

Until mid-February, markets seemed quite sanguine about the effects of COVID-19, but that has all changed.

Across most major bourses, prices have declined sharply. A spike in risk aversion pushed the Chicago Board Options Exchange's Volatility Index (VIX) up to its highest level since 2015. Meanwhile, a flight to quality increased the price of safe-haven assets, such as high-quality bonds and reserve currencies. Spreads on lower-quality borrowers in both the sovereign and corporate spaces widened substantially.

For the GCC region, this means issuers that have weaker credit quality or significant direct exposure to affected industries will find it difficult to access capital markets. A few bond and sukuk issuances have been cancelled because of the less-supportive market conditions, even though performance in the first two months of 2020 was strong. The volume of sukuk issued increased to \$8.6 billion in the first two months of 2020, from \$5.8 billion in the same period of 2019. Similarly, the volume of bond issuances was stable at \$18 billion in the first two months of 2020, compared with \$17.9 billion in 2019.

It remains to be seen how the reduction in interest rates will play out for issuers in the region. However, we anticipate that rising pressure on cash flows and earnings will test the ability of certain players to access the market. Lower-rated issuers and those most directly exposed to the travel, tourism, and consumer spending industries will suffer most. Issuers based in Oman or Bahrain, plus some of those in Dubai, may face obstacles in refinancing their maturing debt or deficits.

### GCC Banks' Creditworthiness Is Likely To Suffer In Line With Clients

The knock-on effects of lower economic growth and oil prices will further slow lending growth and increase the overall stock of problem assets (Stage 2 and Stage 3 loans) at GCC banks. As a result, we anticipate that cost of risk

will edge up. At the same time, interest margins will decline because the U.S. Federal Reserve Board and other local central banks have cut interest rates. Combined, these shifts will weaken banks' profitability.

In the UAE and Bahrain, regulators have allowed banks to implement measures such as rescheduling loans, granting temporary deferrals on monthly loan payments, and reducing fees and commissions for affected customers. Other regulators in the region could follow suit in the next few weeks to help banks cope with the effects of the economic slowdown on their profitability. However, any loans shown forbearance of this sort will likely be classified as Stage 2 loans.

Capitalization is unlikely to be affected by these changes and it should continue to support bank ratings. On the funding side, the lower oil price is likely to slow deposit base growth because government and government-related entities still represented 10%-34% of total deposits on June 30, 2019. The effect of this trend on banks' funding and liquidity profiles will be tempered by slower expansion in lending.

### Related Research

- Unrestrained Supply Swamps Oil Outlook: S&P Global Ratings Revises Oil & Gas Assumptions, March 9, 2020
- Global Credit Conditions: COVID-19's Darkening Shadow, March 3, 2020
- Coronavirus Impact: Key Takeaways From Our Articles, Feb. 12, 2020
- Global Credit Conditions: Coronavirus Casts Shadow Over Credit Outlook, Feb. 11, 2020
- Coronavirus To Inflict A Large, Temporary Blow To China's Economy, Feb. 7, 2020

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# GCC Banks Face An Earnings Shock From The Oil Price Drop And COVID-19 Pandemic

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**S** &P Global Ratings believes conventional and Islamic banks in the Gulf Cooperation Council (GCC) countries will see significantly reduced revenue and credit growth in 2020. The sharp drop in oil prices and measures implemented by regional governments to contain transmission of the coronavirus (COVID-19) will take a toll on important sectors such as real estate, hospitality, and consumer-related. Under our base-case scenario, we assume that these measures will be relatively short lived and forecast a gradual recovery in nonoil activity from third-quarter 2020. However, the severe shock could cause irreparable damage to some parts of the nonoil economy. Furthermore, if the recovery takes longer than we expect, GCC banks could feel greater pressure (see “Composition Of Our Sample” section for additional details).

## Key Takeaways

- The COVID-19 pandemic will halt growth at GCC Islamic and conventional banks in 2020 as they focus on preserving asset quality rather than business expansion.
- The sharp decline in oil prices, accelerated real-estate price corrections in some markets, and drop in vital nonoil economic sectors will pressure banks' earnings, but it shouldn't be a capital event for most at this time.
- Islamic banks are likely to see a greater effect on asset-quality indicators since they typically have a higher proportion of exposure to real estate and cannot charge late payment fees.
- Stimulus and support measures from GCC governments will help banks navigate the challenging environment but likely not resolve structural problems unless we see stronger intervention.

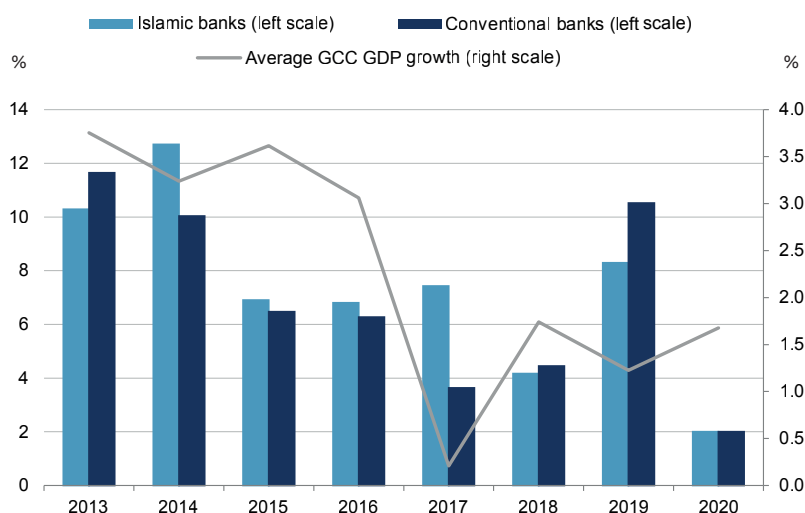
S&P Global Ratings acknowledges a high degree of uncertainty about the rate of spread and peak of the COVID-19 outbreak. Some government authorities estimate the pandemic will peak about midyear, and we are using this assumption in assessing the economic and credit implications. As the situation evolves, we will update our assumptions and estimates accordingly.

## We Expect A Significant Slowdown In Lending Growth In 2020

Although growth rates last year were almost the same as 2018, GCC conventional banks saw faster increases than Islamic banks. This was mainly explained by acquisitions. Emirates NBD, for example, acquired DenizBank in Turkey, increasing its total assets by almost one-quarter. Other transactions were mainly local or regional with Abu Dhabi Commercial Bank absorbing two other local banks (including one Islamic) and Saudi British Bank taking over another local bank. In 2020, we expect slower organic and nonorganic growth, with Islamic and conventional banks seeing similar rates of 2%-3%.

We project average real GDP growth for the six GCC countries will slightly accelerate in 2020 compared with 2019, but this will be primarily spurred by higher oil production (see chart 1). With the significant decline in oil prices--our assumption for 2020 is now an average of \$30 per barrel, down from \$60 at the start of the year--and government measures to contain the spread of COVID-19, we think that nonoil growth will decline. This will result in fewer growth opportunities for banks. We also expect banks to focus more on asset-quality indicator preservation than generating new business. In our forecasts, we assume that measures implemented by the GCC governments to contain COVID-19 are relatively short lived. If this assumption does not materialize, the effect on their economies and banking systems would be stronger than we currently forecast. This risk is exacerbated by delays or cancellations of important events scheduled in the region. The delay of Expo 2020 for Dubai and cancellation of the pilgrimage season for Saudi Arabia, for example, now depend on the spread and containment of COVID-19. If either event is cancelled, the impact on regional economies could be stronger than we currently expect and further increase risks for banks.

**Chart 1 - Asset Growth Comparison: GCC Islamic Vs. Conventional Banks (2013-2020)**



Source: S&P Global Ratings and GCC Central Banks.  
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**Table 1 - Balance Sheet Growth In Selected GCC Islamic Bank Markets 2013-2019**

(Mil \$)	2013	2014	2015	2016	2017	2018	2019
<b>Qatar</b>	48864	58930	68970	75221	82395	82616	89746
Annual growth rate (%)	8.9	20.6	17	9.1	9.5	0.3	8.6
Relative weight is sample (%)	15.3	16.3	17.9	18.1	18.5	17.7	17.7
<b>Kuwait</b>	78457	85688	83461	83560	89138	92849	104673
Annual growth rate (%)	7.9	9.2	-2.6	0.1	6.7	4.2	12.7
Relative weight is sample (%)	24.5	23.7	21.6	20.1	20	19.9	20.7
<b>Saudi Arabia</b>	117097	133315	138207	150464	157221	168785	183549
Annual growth rate (%)	9.2	13.9	3.7	8.9	4.5	7.4	8.7
Relative weight is sample (%)	36.6	36.9	35.8	36.2	35.2	36.1	36.3
<b>United Arab Emirates</b>	75674	82961	95660	106191	117278	123060	127675
Annual growth rate (%)	15.7	9.6	15.3	11	10.4	4.9	3.7
Relative weight is sample (%)	23.6	23	24.8	25.6	26.3	26.3	25.3
<b>Total</b>	320092	360894	386298	415435	446032	467310	505642

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



## Cost Of Risk Will Increase

Lower economic growth and significant shocks to vital economic sectors such as real estate, hospitality, and consumption mean that GCC banks' asset-quality indicators (both Islamic and conventional) will deteriorate in 2020. At year-end 2019, the average nonperforming financing (NPF) ratio reached 2.8% for Islamic banks compared with 3.0% for conventional banks in our sample (we don't see much significance in the slight difference). The coverage ratios were also comparable at 155.5% for Islamic banks and 154.6% for conventional banks at the same date. For 2020, we think that NPF ratios could easily double, and cost of risk could reach 1.5%-2.0% of total loans. Moreover, we believe that most of the deterioration would come from small and midsize enterprises (SMEs) and companies operating in the real estate, hospitality, and consumer-related sectors. In our assumptions, we factor the measures decided by GCC governments to support their economies (see Appendix). Although these measures are helpful, they will primarily give banks time rather than resolve problems related to lost activity of clients with cash flow pressure. In our view, recapitalization or stronger measures to alleviate pressure on clients' bottom lines could make a difference, but there are no indications that governments will move in this direction.

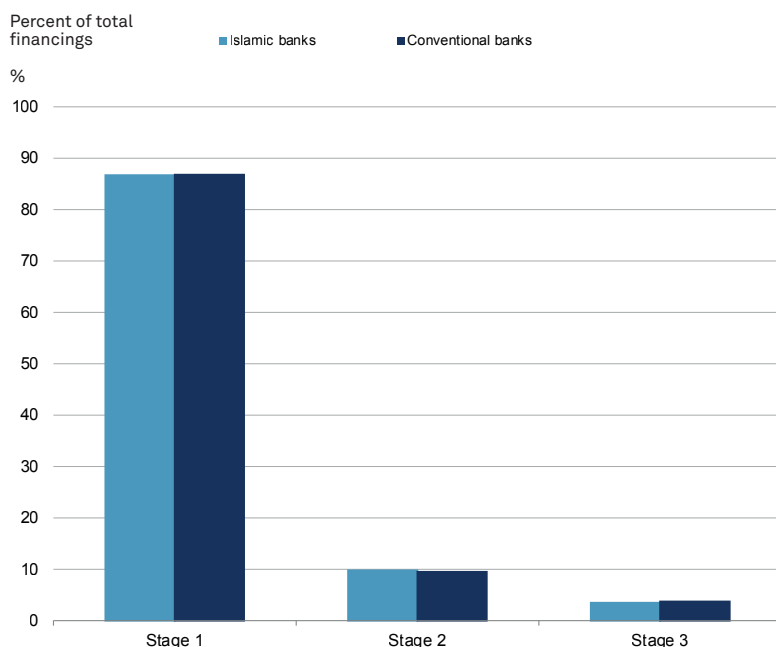
**Table 2 - Asset Quality Comparison: GCC Islamic and Conventional Banks 2013-2019**

<b>Islamic banks (%)</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>2019</b>
Nonperforming advances ratio	4.3	3.2	2.7	2.7	2.8	2.6	2.8
Nonperforming advances coverage	104.2	121	136.2	144.6	146.8	182.4	155.5
New loan loss provisions/average customer loans	1	0.8	0.9	0.8	0.8	0.6	0.7
<b>Conventional banks (%)</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>2019</b>
Nonperforming advances ratio	3.4	2.8	2.4	2.6	2.7	3.1	3
Nonperforming advances coverage	134.5	167.5	167.7	154.5	152	166.5	154.6
New loan loss provisions/average customer loans	1	0.9	0.9	1.2	1	1.1	1.3

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

The International Financial Reporting Standards (IFRS) 9 numbers for banks that reported them in our sample provide a similar picture (see chart 2). At year-end 2019, about 10% of Islamic and conventional banks' assets were in the Stage 2 category. The proportion of problematic assets (Stage 2 and 3) for both industries stood at about 13% of total assets at the same date. We expect some migration to Stage 3 from Stage 2 and think the overall amount of problematic assets could increase to about 20% of total loans by year-end 2020. Our expectation is based on two assumptions:

- Banks recognize the full extent of their asset-quality problems this year. If not, we think the effect will show in 2021.
- Nonoil activity normalizes from third-quarter 2020. The pace of that normalization remains uncertain, however.

**Chart 2 - IFRS 9 Gives The Same Reading For Asset Quality**

IFRS--International Financial Reporting Standards. Source: S&P Global Ratings and GCC Central Banks.  
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In our view, Islamic banks are somewhat more vulnerable than their conventional peers. This is because they tend to have higher exposure to the real estate sector due to the asset backing principle inherent to Islamic finance. Furthermore, they cannot charge late payment fees (unless these are donated to charities at the end of the exercise) meaning that clients tend to prioritize payments on conventional exposures versus Islamic. However, GCC governments' requests for all banks not to charge late payment fees when they reschedule financings to affected companies partially mitigates this distinction.

These vulnerabilities are also somewhat mitigated by the comparable business models of both bank types, consisting primarily of collecting deposits and extending financings to the real economy in their countries. Some market observers might argue that Islamic banks should be more resilient because of the asset backing principle, which results in stronger collateral coverage. We believe that collateral realization is still difficult in the GCC, although some authorities have implemented more creditor-friendly regulation over the past three years. In addition, real estate is one of the most preferred collateral instruments and its value has been declining for all the GCC markets over the past three years.

## Funding And Liquidity Remains Good

Growth in customer deposits was strong in 2019 for both types of banks thanks to the recovery in oil prices. The funding profile of Islamic and conventional banks also remained stable, with total financing to total deposits of about 93% at year-end 2019. We see two main risks in 2020. These include the concentration of the deposits base on government and government-related entity (GRE) deposits, which account for 10%-35% of total deposits. These entities might burn cash as the drop in oil prices and less supportive economic environment affect their activities. Furthermore, we note risks related to deposits outflows once the COVID-19 pandemic is contained and the full effect on employment is known. Some expatriates might increase remittances to their home countries.

Despite this pressure, we continue to take comfort from GCC banks' good liquidity indicators. We note that Islamic banks are in a weaker position (see table 3), but think that this is because the calculation below excludes some of the interbank deposits reported as commodities murabaha.

Banks' funding profiles remain a strength in most GCC countries. We reflect this in our Banking Industry Country Risk Assessments (BICRAs) through systemwide funding, which positively influences our assessment of the starting point (anchor) for some bank ratings. The use of wholesale or external funding sources by regional banks remains relatively limited and we don't think this will change in the short term. The only exception is Qatar, where the banking system still carries significant net external debt. We think that this position will reduce because of COVID-19-induced market volatility. We also take comfort from the government's strong capacity and willingness to provide the sector with support in case of need. The government of Qatar and its related entities injected up to \$42.5 billion in 2017 to help the banking system deal with boycott-related outflows.

**Table 3 - GCC Banks' Key Funding and Liquidity Metrics 2013-2019**

<b>Islamic banks (%)</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>2019</b>
Growth in customer deposits	N.A.	14.8	6.2	4.9	7.3	3.5	9.7
Liquid assets/total assets	27.1	26.5	24.6	23.7	22.1	22.4	22.3
Customer loans (net)/customer deposits	85.9	86.3	90.2	92.1	91.5	91.6	93.1
<b>Conventional banks (%)</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>2019</b>
Growth in customer deposits	N.A.	8.2	4.4	5.1	3.6	4.6	10
Liquid assets/total assets	26.3	26.7	26.3	26.9	26.5	26.8	27.4
Customer loans (net)/customer deposits	90.1	91.9	93.7	94	93.3	92.9	92.8

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

## External Headwinds Will Lower Earnings But Most Banks Will Remain Profitable

We anticipate that both Islamic and conventional GCC banks' profitability will take a hit in 2020.

This is because financing growth will remain limited, with banks focusing more on preserving their asset-quality indicators than generating new business amid the COVID-19 pandemic. We also believe intermediation margin will decline given the reduction in interest rates and the structure of GCC Islamic and conventional banks' funding profiles (with a significant contribution of noninterest-bearing deposits). Furthermore, we expect asset quality will deteriorate and cost of risk will increase. In fact, we do not exclude a doubling of credit losses. During the previous oil price drop, the move to IFRS9 and the charging of the opening effect to equity helped banks. This time, the economic shock is stronger and the full impact will be reflected on banks' bottom lines. In our view, the support measures enacted by GCC governments will at best delay this problem, in the absence of additional measures.

However, we believe banks will continue to benefit from their relatively low cost base and potential additional cost-saving initiatives from 2021. Some banks announced employment-preservation measures for 2020 but cuts will probably come next year if the environment doesn't improve. Investment revenue is also likely to support the bottom line of some banks this year as the drop in interest rates increases the market value of these instruments and banks decide to offload them, thereby realizing gains.

It is important to repeat our assumptions of COVID-19 containment and the resumption of nonoil activity by third-quarter 2020. Should this take longer, it would mean lower profitability and even losses for some banks.

**Table 4 - GCC Banks' Return on Assets 2013-2019**

<b>Islamic banks (%)</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>2019</b>
Average intermediation margin	2.8	2.7	2.7	2.6	2.7	2.6	2.6
New loan loss provisions/average customer loans	1	0.8	0.9	0.8	0.8	0.6	0.7
Return on assets	1.6	1.6	1.7	1.5	1.6	1.6	1.6
Noninterest expenses/operating revenue	41.1	41.4	39.7	41	40.7	40.8	40.2
<b>Conventional banks (%)</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>2019</b>
Average intermediation margin	2.8	2.7	2.5	2.5	2.6	2.7	2.6
New loan loss provisions/average customer loans	1	0.9	0.9	1.2	1	1.1	1.3
Return on assets	1.8	1.9	1.7	1.4	1.5	1.5	1.4
Noninterest expenses/operating revenue	35.3	35.7	36	36.6	38	36.4	37.2

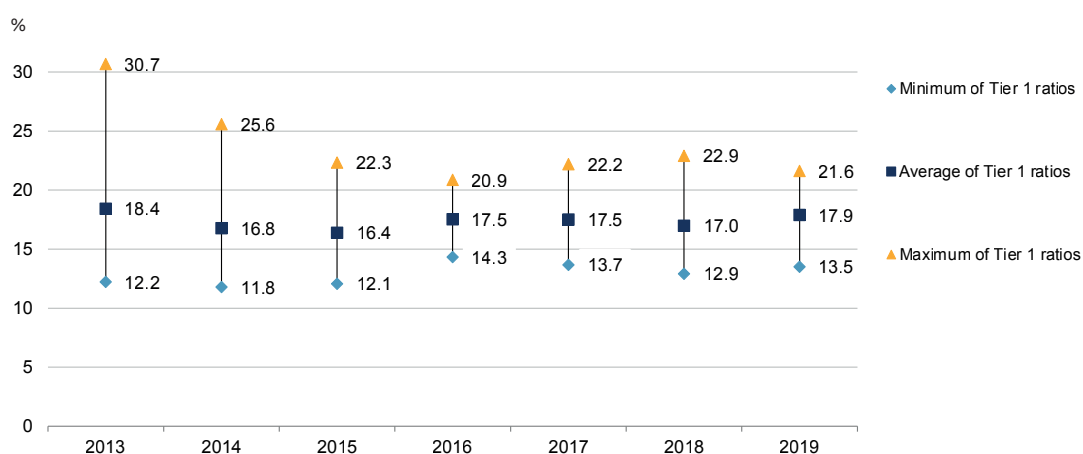
Source: S&P Global Ratings and banks' financial statements.

## Capital Buffers Remain Strong

GCC Islamic and conventional banks included in our sample continue to display strong capitalization by international standards, with an unweighted average Tier 1 ratio of 17.9% for Islamic banks and 16.6% for conventional banks at year-end 2019. After dropping in 2018, this ratio increased slightly in 2019 as some banks raised new capital in the form of Tier 1 instruments before the market turmoil. Under our base-case scenario, we expect capitalization to continue to support the creditworthiness of GCC banks in 2020.

It is our understanding that Oman is the only GCC country to progress toward a recovery and resolution regime. The sultanate 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.

**Chart 3 - GCC Islamic Banks' Reported Tier 1 Ratios 2013-2018**



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

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## A Second Wave Of Mergers And Acquisitions Could Begin

When the dust settles and the full effect of current conditions on banks' financials is visible, we think there could be a second wave of mergers and acquisitions (M&A). The first wave was spurred by shareholders' desire to reorganize their assets. The second wave will be more opportunistic and driven by economic rationale. The current environment might push some banks to find a stronger shareholder or join forces with peers to enhance resilience. We think a second wave of M&A might involve

consolidation across different GCC countries or emirates in the United Arab Emirates (UAE), for example. This would require more aggressive moves by management than those seen in the past. The added hurdles of convincing boards and shareholders, who face the possibility of seeing their assets diluted or losing control, might be easier if they have to recapitalize their banks anyway.

### Which Banks Will Be Most Affected?

In response to the COVID-19 pandemic, GCC governments have announced several measures to help corporates and retailers navigate the challenging environment. Some governments have opted for reduced taxes and levies. Other have asked banks to extend additional subsidized loans to affected clients to maintain employment and avoid production capacity destruction during what is expected to be a short-term event. To our knowledge, no regional governments have announced wide measures that would remove credit risk from banks' balance sheets or inject additional capital. As a result, we think that risks will continue to build and ultimately weigh on banks' financial profiles if the crisis worsens.

In this environment, we see banks in the UAE, Oman, and Bahrain as the most exposed. For Oman and Bahrain, the lack of capacity to support the banking system (in the form of capital injections if needed) means that these governments would need to prioritize the allocation of their limited financial resources if the shock is stronger than expected. For the UAE, the simultaneous shocks to several sectors of the economy and the federal structure of the country would also likely result in a greater effect on asset quality and potentially some selectiveness in extending support to corporates and GREs. The large debt of Dubai-based GREs and lack of access to capital markets will potentially accentuate this pressure.

Moreover, the question of resource allocation between smaller and richer emirates might be raised if conditions worsen. We continue to believe that, in case of need, the federal authorities will intervene and support banks in the UAE.

For Kuwait, we think that even if the situation worsens the government will use its vast financial resources to directly support the financial system, given its long track record of doing so. In Qatar, we also expect direct intervention in terms of exposure buybacks or capital injection should the need arise. We think that Qatari banks' asset-quality indicators will deteriorate but the large state footprint in the economy will act as a backstop. In Saudi Arabia, we also think that asset-quality indicators will deteriorate, especially given current conditions come at a time when the private sector was already under significant pressure. However, we note that most bank growth in recent years was spurred by mortgages to Saudi nationals, who are predominantly working for the government. If the pilgrimage season is cancelled, we think the shock to the private sector will be stronger and the effect on asset-quality indicators will be more visible.

### Composition Of Our Sample

To assess the financial performance of Islamic and conventional banks in the GCC, we used a sample of 16 Islamic banks and 26 conventional banks with total assets in excess of \$2.2 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 data distortion (since these windows/activities benefit from the overall support of their respective groups in the form of funding or cost sharing, for example).

## Study sample details

**Table 5 - Key Performance Indicators For Our Sample Of GCC Islamic Banks, Dec. 31, 2019**

(Bil \$)	Country	Islamic bank ranking	Overall ranking	Assets (bil. \$)
Al Rajhi Bank	Saudi Arabia	1	6	102.4
Kuwait Finance House	Kuwait	2	11	64
Dubai Islamic Bank	United Arab Emirates	3	12	63.1
Qatar Islamic Bank Q.P.S.C.	Qatar	4	15	44.9
Bank Al-inma	Saudi Arabia	5	19	35.1
Abu Dhabi Islamic Bank PJSC	United Arab Emirates	6	20	34.3
Masraf Al Rayan	Qatar	7	25	29.2
Al Baraka Banking Group B.S.C.	Bahrain	8	27	26.2
Bank Aljazira	Saudi Arabia	9	29	23.1
Bank Albilad	Saudi Arabia	10	30	22.9
Emirates Islamic Bank PJSC	United Arab Emirates	11	32	17.6
Boubyan Bank K.S.C.P.	Kuwait	12	33	17.5
Qatar International Islamic Bank	Qatar	13	36	15.6
Ahli United Bank K.S.C.P.	Kuwait	14	38	14.4
Sharjah Islamic Bank	United Arab Emirates	15	39	12.6
Kuwait International Bank K.S.C.P.	Kuwait	16	42	8.9

Ranking by total assets. Source: S&P Global Ratings.



**Table 6 - Key Performance Indicators For Our Sample Of GCC Conventional Banks, Dec. 31, 2019**

(Bil \$)	Country	Conventional bank ranking	Overall ranking	Assets (bil. \$)
Qatar National Bank (Q.P.S.C.)	Qatar	1	1	259.5
First Abu Dhabi Bank P.J.S.C.	United Arab Emirates	2	2	223.8
Emirates NBD PJSC	United Arab Emirates	3	3	186
The National Commercial Bank	Saudi Arabia	4	4	135.2
Abu Dhabi Commercial Bank PJSC	United Arab Emirates	5	5	110.3
National Bank of Kuwait S.A.K.	Kuwait	6	7	96.6
Riyad Bank	Saudi Arabia	7	8	70.9
The Saudi British Bank	Saudi Arabia	8	9	70.8
Samba Financial Group	Saudi Arabia	9	10	68.1
Arab National Bank	Saudi Arabia	10	13	48.9
Banque Saudi Fransi	Saudi Arabia	11	14	47.5
Mashreqbank	United Arab Emirates	12	16	43.4
The Commercial Bank of Qatar	Qatar	13	17	40.5
Ahli United Bank B.S.C.	Bahrain	14	18	40.3
BankMuscat S.A.O.G.	Oman	15	21	31.9
Gulf International Bank B.S.C.	Bahrain	16	22	30.2
Arab Banking Corp. B.S.C.	Bahrain	17	23	30.1
Doha Bank Q.P.S.C.	Qatar	18	24	29.7
The Saudi Investment Bank	Saudi Arabia	19	26	26.9
Burgan Bank	Kuwait	20	28	23.4
Gulf Bank	Kuwait	21	31	20.6
Al Ahli Bank of Kuwait K.S.C.P.	Kuwait	22	34	16.1
Commercial Bank of Kuwait	Kuwait	23	35	16.1
The National Bank of Ras Al-Khaimah	United Arab Emirates	24	37	15.6
Ahli Bank Q.S.C.	Qatar	25	38	12.1
National Bank of Fujairah PJSC	United Arab Emirates	26	41	11.7

Ranked by total assets. Source: S&P Global Ratings.

## Appendix

### GCC Policy Responses

Country	Measures
Kuwait	The authorities have imposed partial curfew and travel restrictions. Among other measures, they suspended inbound commercial flights; closed schools; and suspended nonessential work at governmental entities. The Central Bank of Kuwait (CBK) reduced interest rates on all monetary policy instruments by 1% and committed to provide liquidity as needed. The CBK also instructed banks to support affected businesses and SMEs. Kuwait Banking Association announced that banks will postpone loan payments and cancel interest and any other fees for Kuwaiti clients, including SMEs, for six months.
Oman	The authorities have imposed travel restrictions; closed all schools and shopping malls; and limited employee attendance at government workplaces. Measures to support the economy include the suspension of municipal taxes, some government fees (until Aug. 31, 2020) and rent payments for companies in industrial zones (for the next three months); reduction of port and air freight charge; and postponement of loan servicing for Oman Development Bank borrowers and an SME support fund for six months. The Central Bank of Oman also announced policy measures including a reduction in interest rates; increasing the capital conservation buffer by 50%; increasing the lending ratio by 5%; accepting the deferment of loans payments for the next six months without any effect on risk classification; and deferring the risk classification of loans related to government projects for six months.
Bahrain	The authorities have expanded social distancing and stay-at-home measures over the past few weeks including, among others, closing schools and retail shops, and suspending flights to infected areas. The government also announced a \$1.5 billion stimulus package, effective for three months. The seven-initiative package includes: payment of salaries for Bahrainis working in the private sector; payment of electricity and water bills for Bahraini individuals and companies; exemption of commercial entities from municipality fees, tourist facilities from tourism fees, and industrial and commercial entities from paying rent to the government; doubling the size of the liquidity fund to support SMEs; and use of a government vehicle to support affected companies. The Central Bank of Bahrain (CBB) has also expanded its lending facilities to banks by up to Bahraini dinar 3.7 billion to facilitate deferred debt payments and extension of additional credit. The CBB also cut interest rates, reduced the cash reserve ratio for retail banks to 3% from 5%, relaxed loan-to-value ratios for new residential mortgages, capped fees on debit cards, and requested banks to offer a six-month deferral of repayments without interest or penalty and to refrain from blocking customers' accounts if a customer has lost his or her employment.
Saudi Arabia	The authorities have implemented a range of measures including a nighttime curfew for 21 days; travel restrictions; closing all schools and shopping malls; suspending employee attendance at government and private workplaces; and increasing testing. A Saudi riyal (SAR) 70 billion (\$18.7 billion or 2.7 percent of GDP) private sector support package was announced. It includes the suspension of government tax payments, fees, and other dues to provide liquidity to the private sector and an increase in available financing through the National Development Fund. The Saudi Arabian Monetary Authority has reduced its policy rates and announced a SAR50 billion package to support the private sector, particularly SMEs, by providing funding to banks to allow them to defer payments on existing loans and increase lending to businesses. The central bank will also cover fees for private sector stores and entities for point-of-sale and e-commerce transactions for three months.

## Appendix (continued)

## GCC Policy Responses

Country	Measures
United Arab Emirates	The authorities have enacted several measures including closure of schools, shopping malls, and various tourist attractions. They have also imposed wide-ranging travel restrictions, and enacted teleworking arrangements in government offices. In addition, the authorities have increased testing and scaled up disinfection efforts. The support measures announced by the authorities include: UAE dirham (AED) 16 billion (\$4.4 billion) to support the private sector by reducing various government fees and accelerating existing infrastructure projects; AED1.5 billion (\$0.4 billion) in measures by the government of Dubai to reduce government fees, provide additional water and electricity subsidies, and simplify business procedures; AED9 billion (\$2.5 billion) announced by the government of Abu Dhabi as part of the ongoing fiscal stimulus program. The new initiatives provide water and electricity subsidies as well as credit guarantees and liquidity support to SMEs. In addition, the government of Abu Dhabi has announced a reduction or suspension of various government fees and penalties, as well as a rebate on commercial lease payments in the tourism and hospitality sectors. The Central Bank of the UAE (CBUAE) has reduced interest rates by a combined 125 basis points (bps) and put in place an AED100 billion package. This includes: Zero-interest-rate collateralized loans to banks (AED 50 billion); allowing the use of banks' excess capital buffers (AED50 billion); a 15%-25% reduction in provisioning for SME loans; the increase of loan-to-value ratios for first-time home buyers by five percentage points; limiting bank fees for SMEs; the waiver of all payment service fees charged by CBUAE for six months; raising the limit on banks' exposure to the real estate sector to 30% of risk-weighted assets, subject to adequate provisioning.
Qatar	Measures implemented to contain the spread of the virus include travel restrictions; suspension of public and private schools; closure of shopping malls; and working from home for vulnerable groups. The authorities announced a Qatari riyal (QAR) 75 billion package targeting SMEs and affected sectors including through six-month exemptions on utilities payments (water and electricity) and rent payments for logistics areas and SMEs, and the exemption of food and medical goods from customs duties for six months. The Qatar Central Bank (QCB) lowered its policy rates by 100 bps-175 bps, depending on the rate, and said that it will provide additional liquidity to banks operating in the country. The QCB has put in place mechanisms to encourage banks to postpone loan installments and obligations of the private sector with a grace period of six months. The Qatar Development Bank will postpone installments of all borrowers for six months. Furthermore, government funds have been directed to increase investments in the stock market by QAR10 billion (\$2.75 billion).

This table may not reflect all the measures announced by GCC governments. Source: S&P Global Ratings and the IMF.

## Related Research

- Bahrain-Based GFH Financial Group Downgraded To 'B-' On Deteriorated Market Conditions; Outlook Stable, March 30, 2020
- Outlooks On Five UAE Banks Revised To Negative On Deteriorating Operating Environment, March 26, 2020
- BankMuscat S.A.O.G. Long-Term Rating Lowered To 'BB-' Following Sovereign Downgrade; Outlook Negative, March 30, 2020
- Prolonged COVID-19 Disruption Could Expose The GCC's Weaker Borrowers, March 11, 2020
- Ratings On Two Kuwaiti Banks Lowered On Weaker Support Assumption, March 30, 2020

*This report does not constitute a rating action.*

# Will COVID-19 And Cheap Oil Reset The Market For GCC Tier 1 Instruments?

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Over the past five years, banks in the GCC have raised about \$12.2 billion of capital using listed hybrid instruments, and an additional about \$8 billion were raised using over-the-counter hybrid instruments. These instruments are generally perpetual and callable after five years or every following year at the issuer's option. Moreover, issuers typically have the capacity to defer coupon payment with investors having no recourse in such circumstances. The dual shock of COVID-19 and declining oil prices is raising several questions about these instruments among investors.

## Key Takeaways

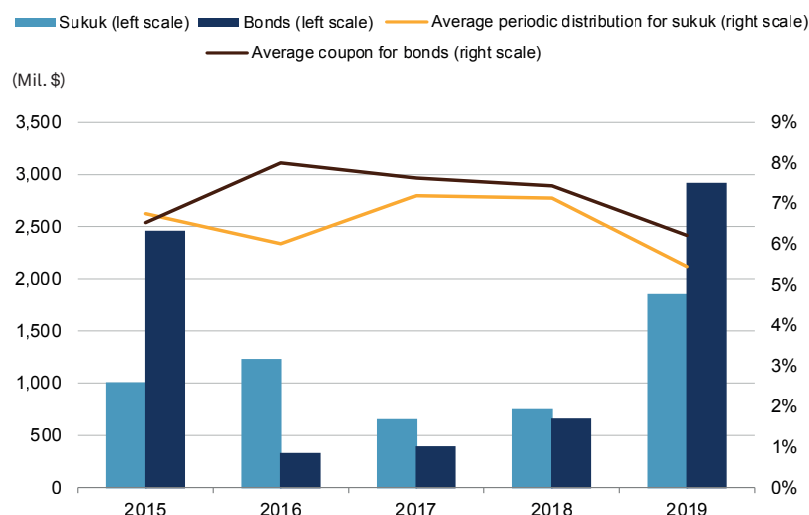
- Gulf Cooperation Council (GCC) banks have raised around \$20 billion of hybrid capital instruments over the past five years and some of them are reaching their first call dates in 2020.
- We see COVID-19 pandemic and the drop in oil price as a profitability rather than a capital event, and therefore we do not foresee banks systematically skipping coupon payments on their hybrid instruments or writing down the principal amount.
- Some issuers already proactively refinanced some instruments approaching their first call date in 2020, benefiting from then-supportive market conditions. We expect such issuers to call the instruments unless the regulator prevents them from doing so or the banks' decide to extend call dates.
- For others, the decision to call or not to call their instruments in 2020 will be purely motivated by such a move's economic impact on the bank.

## Frequently Asked Questions

### What type of instruments were issued?

Over the past five years, most of the capital-raising exercises were through hybrid instruments. GCC banks raised \$12.2 billion of listed additional Tier 1 (AT1) capital instruments with \$5.5 billion of Tier 1 sukuk and \$6.7 billion of conventional instruments. They raised an additional \$8 billion of unlisted instruments, as well during this time. Banks issued these instruments, because they qualified under local regulation as Tier 1 capital instruments and their cost was relatively competitive compared with banks' cost of equity (see chart).

### Hybrid Capital Issuance In The GCC



GCC--Gulf Cooperation Council. Source: S&P Global Ratings, Eikon.  
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### What are the typical terms and conditions of these instruments?

Although S&P Global Ratings does not rate most of these instruments, we have incorporated some of them in the total adjusted capital (TAC, S&P Global Ratings' main capital measure defined as the amount of capital a financial institution has available to absorb losses) of some of the banks we rate. We have observed the following characteristics in most of the instruments we included in TAC:

- They are generally perpetual and callable at the option of the issuer after five years and then every following year if the issuer decides not to exercise the first call. If an instrument is called, there is typically a requirement to replace it with at least an equally ranking instrument.
- Generally, the issuers of these instruments have the option to cancel the payment of the coupon (which explains their loss absorption on a going-concern basis, in addition to the flexibility accorded by the perpetual maturities, and the inclusion in our TAC for rated banks). If the issuer decides to cancel the coupon payment, investors have no recourse. However, generally, such a cancellation would activate an ordinary dividend stopper.

- The instrument is typically written down in full or in proportion if the issuer reaches the point of nonviability or if its regulator declares the issuer nonviable. Nonviability would generally mean a breach of the local minimum regulatory capital adequacy requirements. It is not clear if the nonviability includes receiving public sector funding for recapitalization. However, in our opinion, regulators would probably push for a write-down in such a scenario.

In our view, some of these instruments were priced extremely competitively, with some coupon rates in the 4%-5% range. We understand that part of this pricing owed to expectations that government support would be forthcoming under most circumstances, given GCC authorities' long and strong track record of doing that. In cases where we rate such hybrids, we do not consider them as eligible for government support in our methodology, noting their role as regulatory loss-absorbing capital, and we typically use the banks' stand-alone creditworthiness as a starting point for rating them. That explains, for example, why we rate the Tier 1 instruments issued by First Abu Dhabi Bank seven notches below the long-term issuer credit rating on the bank.

In our view, investing in AT1 instruments is not for the faint hearted. They are perpetual instruments and coupon payments are optional. Investors face a variety of risks, including: noncall risk; coupon nonpayment risk; conversion or write-down risk; and regulatory risk (for example, that an instrument may be redeemed earlier than investors' expect because of shifting regulatory standards or expectations).

**Given the double whammy of COVID-19 and the oil price shock, do you expect issuers to suspend coupon or write down principal on these instruments?**

We expect GCC banks will see significantly reduced revenue and credit growth in 2020. The sharp drop in oil prices and measures implemented by regional governments to contain transmission of COVID-19 will hit the important real estate, hospitality, and consumer-related sectors, among others. In response, GCC governments have also announced several measures to help corporations and retailers, including reduced taxes and levies and requests that banks extend additional subsidized loans to affected clients. We therefore think that risks will continue to build and ultimately weigh on banks' financial profiles if the crisis worsens.

Nevertheless, we view the crisis as a profitability event rather than a capital event. That means we still expect most of the banks to generate positive net income in 2020. Therefore, we do not foresee that banks will systematically skip the payment of the coupon on their hybrid instruments or write down the principal amounts. But banks with high exposure to riskier countries (for example, Turkey or Egypt) could be tempted to do just that if the exposure results in significant losses. In addition, if the crisis lasts longer than expected and we start to observe an impact on banks' capitalization, there may be some stress circumstances when banks could consider using these instruments to absorb losses.

**Do you expect instruments with 2020 call dates to be called?**

Some issuers have been proactive and have already refinanced some of their instruments with the first call dates coming up in 2020. They benefited from what were at the time still supportive market conditions. For such banks who have already "replaced" the hybrids that are coming up to a call date, we therefore think they will call the hybrids, unless the regulator prevents them from doing so, or that the management of these banks will decide to extend the call dates by another year to see how the effects from COVID-19 and the oil price decline unfold.

We expect banks that have not already replaced existing hybrids will be more likely to consider not calling at the optional call dates, with their decision influenced by the regulatory stance and their views on the duration of the market stresses and pricing conditions. Market conditions have now shifted, and investors' appetite for risky instruments has reduced significantly. Therefore, for banks that did not refinance their instruments before the crisis, we think the decision to call their instruments in 2020 or not will be purely motivated by the perceived economic impact on the bank. That includes the impact of market conditions and how new pricing benchmarks arising from investor appetite for risk influence the cost of issuing new hybrids. If the bank knows it can refinance at a lower or similar cost because the instrument has been entirely or partly subscribed by a related investors (for example, a government-related entity), it will probably call the instrument. Otherwise, we expect banks to consider rolling these instruments over until conditions in the financial markets are better. There are already several precedents in Europe in which banks decided not to call their hybrid instruments. For example, Santander did so in February of 2019 (see "Will Santander's Decision Not To Call Reset The Market For AT1 Instruments?," published Feb. 13, 2019, on RatingsDirect).

**Is it an event of default if a bank does not call the instrument?**

A bank's decision not to call the hybrid instrument on its optional call date does not constitute a default under our ratings criteria. We view an issuer's ability not to call such a hybrid as a key feature that enhances its flexibility to manage its capital. Indeed, our view of hybrids' ability to be on the balance sheet to absorb losses when needed remains an essential and enduring component of our criteria for assigning equity content to hybrid capital instruments.

A material and persistent adverse investor reaction to an issuer's decision not to call its hybrid instrument could reflect a reputational problem with wholesale investors. This population is more important to some GCC banks than to others, particularly in Qatar where dependence on external wholesale funding is high. Such a reaction could lead us to review our opinion of the bank's access to cost-effective refinancing.



### Related Research

- How Resistant Are Gulf Banks To The COVID-19 Pandemic And Oil Price Shock?, April 22, 2020
- Europe's AT1 Market Faces The COVID-19 Test: Bend, Not Break, April 22, 2019
- Virus, Oil, And Volatility Will Put Sukuk Issuance Into Reverse, April 13, 2020
- GCC Banks Face An Earnings Shock From The Oil Price Drop And COVID-19 Pandemic, April 6, 2020
- Prolonged COVID-19 Disruption Could Expose The GCC's Weaker Borrowers, March 11, 2020
- Coronavirus Increases Risks For Gulf Economies, Feb. 16, 2020
- Will Santander's Decision Not To Call Reset The Market For AT1 Instruments?, Feb. 13, 2019

*This report does not constitute a rating action.*

# AAOIFI's Proposal May Result In Different Interpretations On The Treatment Of Unrestricted Investment Accounts

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(Editor's note: Here, S&P Global Ratings responds to a draft standard by the Accounting and Auditing Organization for Islamic Financial Institutions communicated on Jan. 12, 2020. The views expressed in this response represent those of S&P Global Ratings and do not address, nor are intended 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.)

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## Key Takeaways

- We believe the latest proposal regarding financial reporting from the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) can result in different interpretations on the treatment of unrestricted investment accounts (URIA) and in unforeseen future risks.
- Although URIA could theoretically absorb losses, banks avoid this route since it might lead to liquidity pressure and endanger the sustainability of the banks' themselves.
- Opening the debate on URIA backed by contractual obligations and URIA with real loss-absorption features, notably on their remuneration and treatment from a capital perspective, could help the industry progress.
- Under S&P Global Ratings' criteria for bank and hybrid instruments, URIA is not factored in our capitalization assessment. We assume that banks will not require their depositors to absorb losses on a going-concern basis.

S&P Global Ratings believes the recent proposal by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) for general presentation and disclosures in the financial statements of Islamic banks and financial institutions leaves significant room for interpretation by investors and regulators concerning the treatment of unrestricted investment accounts (URIA). The AAOIFI proposes to treat URIA as quasi-equity instruments, which assumes loss-absorption at some stage. That said, anecdotal evidence suggests that these accounts are not remunerated for that specific risk. Moreover, treating these accounts as quasi-equity instruments would question their bail-in-ability under recovery and resolution regimes. In our view, open debate around the nature of URIA would allow AAOIFI to strengthen its standard with insight from other jurisdictions dealing with these instruments.

### From Investment Accounts To Quasi-Equity

According to AAOIFI's proposed financial accounting standard 1 (FAS 1), quasi-equity is a broader concept that includes URIA and defines it as an element of an Islamic bank's financial statement that represents participatory contributions received by an institution on a profit-sharing or participation basis. It has three main characteristics:

- Loss-absorption except cases of negligence, misconduct, or breach of contractual terms if proved. The bank is not required to return the funds to their providers, and the latter share the residual interest in the underlying assets of the business.
- A maturity or a put option of redemption; and
- Specific features such as limiting the rights of the fund providers to the underlying business or assets and not on the whole institution (for example, no voting rights or other features that relate to equity).

In our view, such a definition might lead to varying approaches on how to treat these instruments by regulators and investors. Under this purist view, Islamic banks are no longer banks, but rather asset managers for URIA-related activity. The only difference with traditional asset managers is that some URIA holders look to keep their money safe and have some return, and are probably not aware that they could lose part of it. This interpretation also assumes that banks will remunerate their depositors in the same way asset managers do.

However, another scenario unfolds. Anecdotal evidence suggests that Islamic banks in the Gulf Cooperation Council (GCC) remunerate their URIA depositors broadly in line with the remuneration they would get from their conventional counterparts. The profit and loss-sharing mechanisms are usually not disclosed and banks use the Mudharib fee, profit equalization reserves (PER), and investment risk reserves (IRR) as adjustment variables if the underlying assets generate stronger or weaker returns. In addition, such a definition assumes that banks will serve any loss on the underlying assets to their depositors or URIA holders. In reality, this doesn't happen because banks know that it could result in significant liquidity pressure from depositors closing down their positions. Also, the amounts of PER and IRR are generally limited and cannot compensate for potential material losses. Furthermore, reporting URIA as quasi-equity instruments could give the misleading impression that some Islamic banks are better capitalized than their peers in the same way that the alpha factor--the percentage of assets excluded from the calculation of regulatory risk-weighted assets--used in the capital adequacy calculation of some banks does, in our view. Moreover, reporting URIA as quasi-equity instruments creates uncertainty on how the regulators would treat them if and when the core Islamic finance markets start to move to a recovery and resolution regime.

### Open Debate Could Clear Up Discrepancies

We believe that other jurisdictions' experience can inform the debate and support the industry's progress. In Malaysia, for example, the regulator isolated Islamic deposits from Islamic investment accounts. In its 2013 Islamic financial services act, the Malaysian regulator defined them as:

- Islamic deposits: Money accepted or paid in accordance with Sharia on terms under which it will be repaid in full with or without remuneration. In practice, they are usually structured using Murabaha, which creates a contractual obligation on the bank to pay the principal amount as well as the remuneration agreed.
- Islamic investment account: Money is paid or accepted for the purposes of investment on terms that there is no express or implied obligation to repay the money in full. In addition, either only the profits or both the profits and losses shall be shared between the person paying the money and the person accepting the money.

This set-up is clear for the different stakeholders involved, and we think that modelling some of this structure would help get the AAOIFI standard closer to market practices. In our view, when applying such a distinction, the reporting of the asset side of the Islamic bank should also segregate the assets financed using URIA, since investors are responsible for the losses generated on these assets in case of need. Strong governance rules would also be needed to ensure that banks are not shifting their riskiest assets to URIA. Furthermore, although URIA and their assets are reported on balance sheet, from a capital adequacy perspective, banks would not be required to cover the full extent of the risks but to set aside some capital for their role as asset managers. The only exception would be if URIA are being used to invest in the overall business of the bank (without specifically segregating their underlying assets from those financed using the bank's and the shareholders' equity). That would be similar to the Tier 1 sukuk instruments where the underlying assets are typically a general participation to the bank's pool of assets. Under such conditions, URIA can serve as a hybrid instrument and absorb losses stemming from the overall business of the bank. That would also mean that the market is likely to price them as capital instruments rather than deposits.

## Why Are These Proposals Important To Ratings?

In our ratings on banks, we do not give credit to the URIA from a capital assessment perspective. That's because, to our knowledge, no commercial Islamic bank has ever served negative returns to its customers and that under stressed circumstances, the shareholders of the bank (or the governments to ensure financial stability in some core Islamic finance markets) are usually called upon to support their depositors. Furthermore, we believe that instruments that qualify for capital content have to achieve a certain degree of permanence. This may not be the case of these URIA, as they tend to be short-term instruments. Moreover, under our methodology, we give capital credit for some hybrid instruments such as the Tier 1 sukuk that were issued by some rated banks in the GCC in the past few years. Clarifying whether URIA should be treated as deposits or as quasi equity could also inform the pricing of these instruments. At this stage, they are usually priced as deposits. If they were to be considered as quasi equity, they might be priced as such, which could affect Islamic banks' cost of funding (assuming depositors will continue to use these instruments).

*This report does not constitute a rating action.*

# COVID-19 And Lower Oil Prices Could Accelerate Consolidation Among Saudi Arabian Insurers

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After a material improvement in growth and earnings in 2019, S&P Global Ratings expects the Saudi Arabian insurance sector to report solid underwriting results in first-half 2020, benefiting from fewer motor and medical claims due to the COVID-19-related lockdown, despite negative economic growth.

## Key Takeaways

- The Saudi Arabian insurance sector recorded a significant improvement in GWP growth and profitability in 2019, mainly because of a stronger earnings at some market-leading insurers.
- We anticipate that the sector will report strong overall underwriting results in first-half 2020, due to a sharp reduction in motor and medical claims offsetting some weaker investment returns.
- However, an increase in claims to more normal levels, constrained economic conditions, a higher VAT rate from July 1, 2020, and social benefit cuts will likely have a negative effect on consumer spending and consequently growth and earnings prospects in second-half 2020.
- In our view, this will further increase competition and accelerate consolidation in the market.

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We now forecast Saudi economic output (measured in GDP) will contract by about 3% in 2020 before we see modest positive growth of 1.6% in 2021 (see “Sovereign Risk Indicators,” published April 24, 2020, on RatingsDirect). As the effects of COVID-19 and lower oil prices evolve, we will update our economic assumptions and estimates accordingly.

With the lifting of strict lockdown measures in late June, we expect that motor and medical claims will pick up, as traffic flow increases and policyholders start returning to hospitals for nonurgent medical services in the coming months. The increase in value-added tax (VAT) to 15% from 5% from July 1 and cuts in social benefits for citizens could further pressure consumer spending, in our view. Insurers are therefore likely to experience a slowdown in premium collections, since many consumers and businesses could delay their premium payments in an attempt to manage cash flows. This would pressure asset quality, liquidity, and consequently credit conditions of some players. However, we expect the sector to still remain profitable overall in 2020, despite slower premium growth and substantially weaker profitability in the second half.

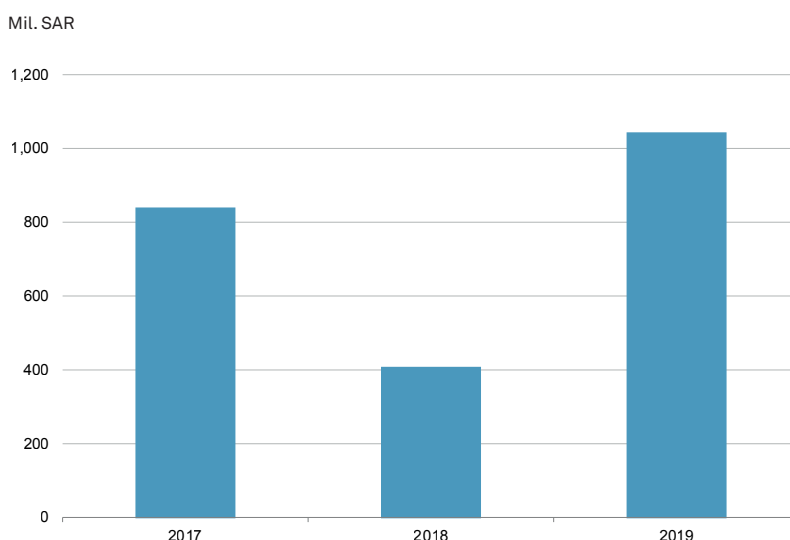
Following two recent merger announcements, we expect to see further and accelerated consolidation in the sector over the coming quarters, given that there is a relatively large number of small and loss-making insurers.

### Better Underwriting Results Are A Key Profitability Driver

Following two years of declining gross written premiums (GWPs), the Saudi Arabian insurance sector saw GWP growth of about 8.3% to Saudi riyal (SAR) 37.8 billion in 2019 from SAR34.9 billion in 2018. This was mainly spurred by rate increases and the extension of mandatory medical cover to a wider part of the population, as some previously loss-making insurers successfully repriced their policies.

At the same time, post-zakat (religious tax) income increased significantly, by about 146% to about SAR1 billion in 2019 from SAR406 million in 2018 (see chart 1). This was mainly due to stronger earnings at some leading insurers including Tawuniya, BUPA Arabia, and MedGulf.

**Chart 1 - Total Post-Zakat Income Of Saudi Insurers In 2017-2019**



SAR--Saudi riyal.

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### Insurers Could Be Negatively Affected By The Weak Economy And A Decline In Disposable Income In The Short Term

Measures taken to contain COVID-19, including travel bans and curfews; lower oil prices, leading to delays or cancellations of nonessential infrastructure projects; and a general decline in disposable income due to the VAT increase and social benefit cuts could negatively affect GWP growth and earnings prospects over the next year.

We anticipate that the number of insured individuals under medical policies will decline and that some employers will opt for more basic and cheaper medical cover for staff in an effort to save costs. A slowdown in economic activity and consolidation in a number of sectors has already led to job cuts and cost-saving measures in recent years. Although the local population continues to expand, this will likely be offset by the departure at least 600,000 (mainly blue-collar) foreign workers that could be forced to leave Saudi Arabia in 2020 due to job losses or Saudization requirements. In addition, consumers will also likely defer purchases of new cars and other items due to economic uncertainty.



Although the introduction of new mandatory medical cover and an effort by the authorities to reduce the number of uninsured cars (currently, only about 50% of cars in Saudi Arabia are adequately insured), will lead to satisfactory growth in the medium term, we now anticipate that total GWP will decline by up to 5% in 2020. In our view, new mandatory medical covers for Hajj and Umrah pilgrims that were introduced in early 2020, but put on hold due to COVID-19-related travel restrictions, could generate additional GWP of SAR1.5 billion–SAR2.5 billion in 2021 and help the market return to growth. However, this is assuming foreign visitors are allowed to attend the pilgrimages next year. We also believe long-term life insurance products, which currently contribute less than 4% of total GWP, may experience an increase in demand, particularly for coverage of critical illnesses.

We understand that the Saudi government has agreed to cover the majority of medical care costs related to COVID-19 and that claims relating to nonurgent medical treatment substantially declined in first-half 2020. In addition, strict lockdown measures also led to a material decline in motor claims during that time. We expect that most insurers will report favorable underwriting results in first-half 2020. However, with the lifting of lockdown measures in late June, we expect that motor and medical claims will return to more normal or slightly elevated levels in the coming months, as traffic flow increases and policyholders start visiting hospitals for nonurgent medical treatment. In addition, insurers have agreed to extend motor policies for two months free of charge, which will broadly offset the decline in claims during the lockdown.

Another key issue for insurers this year will be the VAT increase to 15% on July 1. When a 5% VAT rate was introduced in January 2018, insurers had to cover a substantial part of the tax burden because they were unable to fully recover VAT for policies written in 2017 that extended into 2018. However, we expect the VAT increase this year will have a modest effect on profitability because the General Authority of Zakat and Tax (GAZT) has issued guidance suggesting that the higher rate will not be applicable to policies issued prior to May 11, 2020. Despite this transitional period, insurers might have some additional tax liability for annual policies written between May 11 and July 1. We estimate that this additional tax liability could be up to SAR300 million for the whole market over 2020 and 2021. Although we understand that insurers are permitted to invoice policyholders or offset the additional VAT costs when paying claims, these liabilities may still not be fully recovered.

More broadly, we think profitability could be affected by a likely slowdown in premium collections, since many consumers and businesses could delay their premium payments in an attempt to manage cash flows. Under existing regulations, insurers in Saudi Arabia are required to fully provision for receivables that are outstanding for more than 90 days, which typically has a negative effect on solvency buffers. In anticipation of longer payment cycles, we understand the regulator has granted insurers permission to treat receivable that are outstanding for more than 90 days more favorably--similar to practices in other markets--to ease potential pressures on solvency calculations.

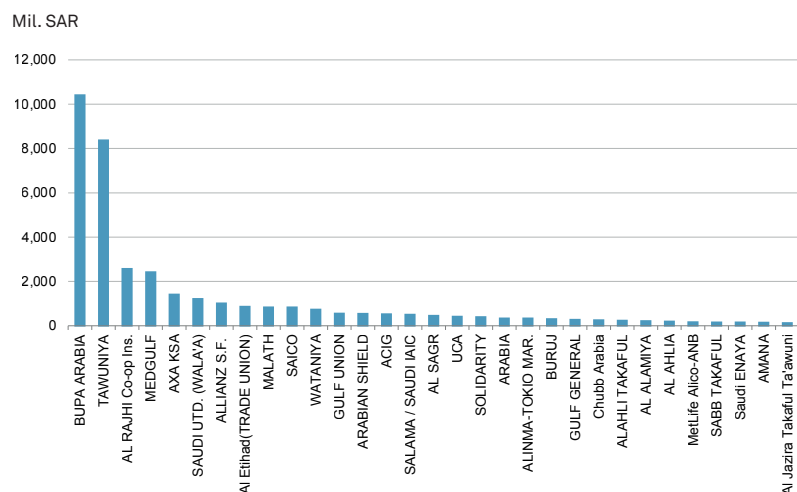
Meanwhile, on the asset side, the sector has limited exposure to risky asset classes such as equity and real estate, which together contribute to less 20% of total investments. However, the equity market (Tadawul) has declined by about 13% in the year to date (June 28). This decline, in combination with lower interest rates, will likely lead to lower investment returns in 2020 than in 2019.

Overall we believe that profitability will decline in 2020 and fall below 2019 levels, when the sector generated a post-zakat profit of about SAR1 billion.

### **Overall Capitalization Remains Satisfactory, But Weak Earnings Will Lead To Further Consolidation**

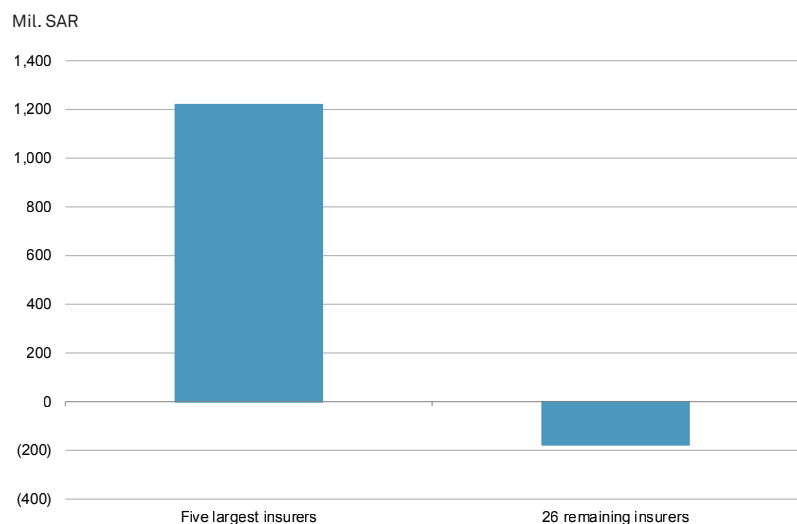
The sector's total shareholder equity increased by about 10% to SAR16.4 billion in 2019 from SAR14.9 billion in 2018, since a number of insurers retained profits or raised additional capital through rights issues. Like the previous year, growth in shareholder equity exceeded premiums in 2019, which indicates a slight improvement in overall capitalization.

However, Saudi Arabia's insurance sector remains highly concentrated in terms of GWP and earnings. In 2019, the five largest primary insurers (out of a total of 32) had a market share of about 68% (2018: about 66%). Moreover, the largest insurer, BUPA Arabia, crossed the SAR10 billion GWP mark for the first time, but there were 13 companies that generated less than SAR367 million (\$100 million) and another six that wrote less than \$200 million.

**Chart 2 - GWP Of Saudi Arabian Primary Insurers In 2019**

GWP--Gross written premiums. SAR--Saudi riyal.

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**Chart 3 - Total Post-Zakat Income Of Saudi's Top 5 Insurers Vs. Remaining 26**

SAR--Saudi riyal.

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There were also differing fortunes across the market, with the five largest insurers by GWP reporting a combined post-zakat profit of about SAR1.2 billion in 2019 and the remaining 26 primary insurers a combined post-zakat loss of about SAR177 million. As in 2018, post-zakat losses were also reported by 13 insurers, representing about 42% of all primary insurers in the market. These companies had a combined market share of about 12%. We therefore believe that credit conditions for these small and loss-making insurers will continue to weaken, while they will remain broadly stable for the market leading players.

Although scale is no guarantee of profitability, it does help insurers to dilute some of their expenses, which are relatively high in Saudi Arabia compared with other markets. We note that three of the 34 insurers have stopped writing business in recent years due to insufficient solvency capital. Following two recent merger announcements, we expect to see further consolidation through mergers or market exits in 2020 and 2021. However, given the relatively large number of loss-making players in the market, mergers will only be beneficial if shareholder expectations are realistic in terms of valuations and companies can benefit from factors such as larger scale, access to new lines of business, or other forms of diversification.

### Related Research

- Insurance Industry And Country Risk Assessment: Saudi Arabia Property/Casualty And Health, May 5, 2020
- Sovereign Risk Indicators, April 24, 2020

*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, 2020
Al Baraka Banking Group B.S.C.	Bahrain	Bank	BB-/Stable/B
GFH Financial Group	Bahrain	Bank	B-/Stable/--
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 (Q.P.S.C.)	Qatar	Bank	A-/Stable/A-2
Al Rajhi Bank	Saudi Arabia	Bank	BBB+/Stable/A-2
Islamic Development Bank	Saudi Arabia	Multinational	AAA/Stable/A-1+
The Company for Cooperative Insurance	Saudi Arabia	Insurance	BBB+/Stable/--
Wataniya Insurance Company	Saudi Arabia	Insurance	BBB/Positive/--
Islamic Corporation for Development of the Private Sector	Saudi Arabia	Multinational	A/Negative/--
Walaa Cooperative Insurance Company.	Saudi Arabia	Insurance	BBB+/Positive/--
AlBaraka Turk Katilim Bankasi AS	Turkey	Bank	B/Negative/B
Islamic Arab Insurance Co. (Salama)	UAE	Insurance	BBB/Negative/--
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	Program 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.	Saudi Electricity Global Sukuk Co.	Corp.	2012	1,250
Majed Al Futtaim	UAE	MAF Sukuk Ltd.	Corp.	2012	3,000
Axiata Group Bhd.	Malaysia	Axiata SPV2 Bhd.	Corp.	2012	1,500
IILM	Malaysia	International Islamic Liquidity Management 2 SA	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
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
DIFC Investment LLC.	UAE	DIFC Sukuk. Ltd	Corp.	2014	700
Emaar Malls Group LLC	UAE	EMG Sukuk Ltd	Corp.	2014	750

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

Obligor	Country	Sukuk/Trust certificates	Sector	Date of Rating	Program or Issued (\$-eq Mn)
Emaar Properties PJSC	UAE	Emaar Sukuk Ltd.	Corp.	2014	2,000
Emirate of Sharjah	UAE	Sharjah Sukuk Limited	Gov.	2014	750
Government of Malaysia	Malaysia	Malaysia Sovereign Sukuk Bhd.	Gov.	2015	1,500
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	3,950
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
Serba Dinamik Holdings Bhd.	Malaysia	SD International Sukuk II Ltd.	Corp.	2020	200
GFH Financial Group	Bahrain	GFH Sukuk Company Ltd.	FI	2020	300

### 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.

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

### **Murabaha**

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

### **Musharaka**

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

### **Profit equalization reserve**

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

### **Profit sharing investment account**

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

### **Qard hasan**

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

### **Retakaful**

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

### **Riba**

Usury.

### **Sharia (or Shari'ah)**

Islamic law.

### **Sukuk**

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

### **Takaful**

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

### **Urbun**

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

### **Wadia**

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

### **Wakala**

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

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



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