



# Islamic Finance Outlook

2022 Edition

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**S&P Global**  
Ratings





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## 2022

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# Islamic Finance 2021-2022

## TOWARD SUSTAINABLE GROWTH

Dr. Mohamed  
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S&P Global Ratings believes the global Islamic finance industry will expand 10%-12% in 2021-2022. The expansion of Islamic banking assets in some Gulf Cooperation Council (GCC) countries, Malaysia, and Turkey and sukuk issuances exceeding maturities explain this expected performance. Islamic finance expanded rapidly in 2020 with total assets increasing 10.6% despite the double shock from the COVID-19 pandemic and drop oil prices. We expect oil prices to stabilize at \$60 per barrel and a modest economic recovery for most core Islamic finance countries in 2021-2022. However, we think the industry will position itself toward more sustainable growth. More specifically:

- 1- We believe that we could see some **advancement in the standardization and integration of the industry**. Over the next 12 months, we could see progress on a unified global legal and regulatory framework for Islamic finance that Dubai and its partners are developing. More importantly, we believe that standardization must be inclusive to avoid situations like those issuers faced with the adoption of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standards in some core countries.
- 2- We may also see **more frequent issuance of dedicated social Islamic finance instruments and green sukuk** as the industry realizes and leverages its alignment with environmental, social, and governance (ESG) values. The aftermath of the pandemic and the agenda for core countries' energy transition could create opportunities to expand these products. We expect adoption will remain slow, however, given the additional complexity related to these instruments and core Islamic finance countries' slow implementation of policies to manage the energy transition.

- 3- We think that **higher digitalization and fintech collaboration** could help strengthen the industry's resilience in more volatile environments and open new avenues for growth. COVID-19 has demonstrated how the capacity of a company or a bank to shift its business online is critical for its continuity. In our opinion, accessing bank services digitally, issuing sukuk on a digital platform using blockchain technology, and enhancing cyber security will be the three main factors to help improve the industry's resilience.

With the right coordination between different Islamic finance stakeholders, we believe the industry can create new sustainable growth opportunities and contribute to shared prosperity. We hope you enjoy the 2022 edition of our Annual Outlook For Islamic Finance, and as always, we welcome and encourage your feedback on our research and insights.

## التمويل الإسلامي 2021-2022: نحو نمو مستدام

د. محمد ديمق

مدير أول والرئيس العالمي للتمويل الإسلامي

تعتقد وكالة «إس أند بي جلوبال للتصنيفات الائتمانية» أن قطاع التمويل الإسلامي سيحقق نمواً يتراوح ما بين 10%-12% في 2021-2022. ويفسر هذا الأداء المتوقع نمو أصول الصيرفة الإسلامية في بعض دول مجلس التعاون الخليجي وماليزيا وتركيا وتجاوز الإصدارات الجديدة الصكوك المستحقة. توسع قطاع التمويل الإسلامي بسرعة في عام 2020 مع زيادة إجمالي الأصول بنسبة 10.6% على الرغم من الصدمة المزدوجة الناتجة عن جائحة كوفيد-19 وانخفاض أسعار النفط. نتوقع استقرار أسعار النفط عند 60 دولار أمريكي للبرميل وتحقيق انتعاش اقتصادي متواضع في معظم دول التمويل الإسلامي الأساسية في 2021-2022. مع ذلك، نعتقد أن القطاع سيتجه نحو نمو أكثر استدامة، وهو ما يمكن تلخيصه في ثلاثة نقاط:

- 1- نعتقد بأننا قد نشهد بعض التقدم في توحيد المواصفات والتكامل في القطاع. قد نشهد خلال 12 شهراً القادمة تقدماً في التوصل إلى إطار قانوني وتنظيمي عالمي موحد للتمويل الإسلامي الذي تعمل دبي وشركاؤها على تطويره. علاوة على ذلك، نعتقد بأن توحيد المواصفات يجب أن يكون شاملاً لتجنب مواقف مثل تلك التي تواجه المصدّرين مع اعتماد معايير هيئة المحاسبة والمراجعة للمؤسسات المالية الإسلامية (أيوبي) في بعض البلدان الأساسية للتمويل الإسلامي.
- 2- قد نشهد أيضاً إصدارات أكثر تواتراً لأدوات التمويل الإسلامي الاجتماعية المخصصة والصكوك الخضراء حيث يستوعب ويستفيد القطاع من توافقها مع القيم البيئية والاجتماعية والحوكمة. قد تخلق الآثار الناتجة عن الجائحة وبرامج التحول في مجال الطاقة فرصاً لتوسيع هذه المنتجات في البلدان الأساسية للتمويل الإسلامي. نتوقع بأن يظل اعتماد ذلك بطيئاً، بالنظر إلى التعقيدات الإضافية المرتبطة بهذه الأدوات وببطء تنفيذ البلدان الأساسية للتمويل الإسلامي لسياسات إدارة تحول الطاقة.

3- نعتقد بأن زيادة التعاون مع قطاعي التكنولوجيا الرقمية والتكنولوجيا المالية يمكن أن يعزز مرونة القطاع في بيئات أكثر تقلباً وأن يفتح آفاقاً جديدة للنمو. أظهرت جائحة كوفيد-19 مدى أهمية قدرة الشركات أو البنوك على توفير الوصول إلى أنشطتها للعملاء عبر الإنترنت للاستمرار في أعمالها. نرى بأن إمكانية الوصول إلى الخدمات المصرفية رقمياً، وإصدار الصكوك عبر المنصات الرقمية باستخدام تقنية "البلوكشين"، وتعزيز الأمن الإلكتروني تشكل ثلاثة عوامل رئيسية تساعد على تحسين استقرار القطاع.

نعتقد بأن القطاع يمكنه خلق فرص جديدة من النمو المستدام والمساهمة في تحقيق الرخاء المشترك من خلال التنسيق الصحيح بين مختلف أصحاب المصلحة في قطاع التمويل الإسلامي.

نأمل بأن تنال نسخة "توقعات التمويل الإسلامي للعام 2022" إعجابكم، ونرحب دائماً بآرائكم وتعليقاتكم حول تحليلاتنا وأبحاثنا.



## Foreword

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

2021 has seen the global Islamic finance industry emerge from the depths of the COVID-19 pandemic in robust health. Against the challenging backdrop last year, global Islamic assets achieved double-digit growth of 10.6%<sup>1</sup> in 2020 and as we look ahead, this growth is expected to continue.

With a total market value of \$2.2 trillion, the global Islamic finance industry is sizeable, catering to the financial needs of around a quarter of the world's population. The Middle East, Africa and South Asia (MEASA) region plays a key role in driving its expansion. Dubai has long been the region's leading international hub for Islamic Finance and is now combining this with a vigorous focus on innovation and financial technology.

The industry-wide growth means that the global value of Sukuk issuances is expected to reach as much as \$155 billion in 2021, up from \$149 billion in 2020 as both corporates and governments tap into Islamic Finance for their ongoing financing needs. In fact, the listed value of Sukuk in Dubai recently reached \$77.56 billion<sup>2</sup>, maintaining the Emirate's status as one of the largest centres for Sukuk listings globally.

Dubai continues to list innovate Sukuk, especially in the Environmental, Social and Governance (ESG) space where it driven some notable firsts in the green Sukuk space. These include the world's first benchmark corporate green Sukuk for Majid Al Futtaim and the world's first sovereign green Sukuk for Indonesia. Dubai is set to benefit from the accelerating demand for ESG-related products.

Complementing Dubai's preeminence in Sukuk issuances, DIFC has 47 active authorised firms which qualify as Islamic Finance institutions and operate as an Islamic window. This includes fully-fledged Islamic institutions

such as Maybank Islamic Berhad, which chose to launch its first overseas branch in DIFC in 2020, highlighting once again the part DIFC plays in bringing together global partners to support the industry's development.

Dubai is also leading the charge in developing a unified global Islamic Finance legal and regulatory framework. Harmonising standards represents a huge opportunity for the industry to streamline and strengthen processes and practices thereby enhancing the appeal of Islamic finance products. We have been working closely with a number of parties in order to bring this project to fruition.

As in so many other industries, digitisation of the Islamic finance industry will be key for future growth. DIFC is nurturing this potential through a comprehensive approach to innovation including developing the right legal and regulatory frameworks, enhancing world-class infrastructure and providing easy access to funding and support.

Our innovation ecosystem brings together pioneering startups with established financial institutions, including those focused on Islamic finance. The DIFC Innovation Hub already accounts for over 60% of the GCC's FinTechs and a recent report<sup>3</sup> ranked the UAE third globally by number of Islamic-finance-focused FinTechs, behind only the UK and Malaysia.

We will continue to help grow the industry by collaborating with our clients and partners across the world. By coming together, we can deliver seamless, secure and smart solutions for the next generation and deliver on the promise of the Islamic finance industry.

<sup>1</sup> <https://www.reuters.com/business/finance/global-islamic-finance-forecast-grow-main-markets-recover-sp-2021-05-03/>

<sup>2</sup> <https://wam.ae/en/details/1395302948217#:~:text=The%20new%20listing%20has%20increased,total%20value%20of%20%2477.56%20billion.>

<sup>3</sup> <https://internationalbanker.com/banking/the-state-of-islamic-banking/>

# Islamic Finance 2021-2022: Toward Sustainable Growth

S&P Global Ratings believes the global Islamic finance industry will grow by 10%-12% in 2021-2022 after slowing to 10.6% in 2020 (excluding Iran). Growth of Islamic banking assets in some Gulf Cooperation Council (GCC) countries, Malaysia, and Turkey and sukuk issuances exceeding maturities explain this performance. Islamic finance grew rapidly in 2020, albeit at a slower pace than in 2019, despite the double shock from the pandemic and the drop in the oil price. We have excluded Iran from our statistics this year owing to the extreme volatility of the country's currency in the parallel market (as disclosed by the Central Bank of Iran), which makes comparison with last year's numbers or any forecasts less meaningful.

## Key Takeaways

- We expect stronger sukuk issuances and expanding market shares amid the modest recovery of core Islamic finance economies to boost Islamic finance assets by around 10%-12% over 2021-2022.
- Although the pandemic offered the possibility of more broad-based and transformative growth, the industry has not yet fully unlocked the opportunities inclusive standardization affords and increased its share of sustainable finance activity.
- Coordination between the different stakeholders is key to the industry leveraging the opportunities related to the energy transition for core Islamic finance countries and wider social challenges.

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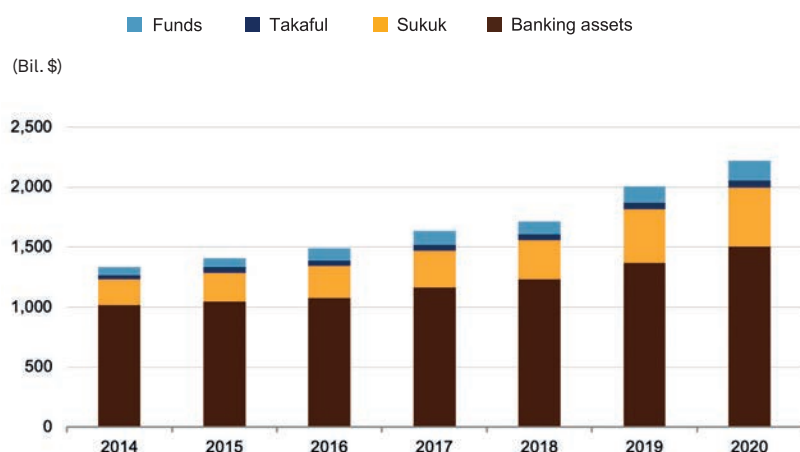
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Although we expect a modest recovery for most core Islamic finance countries in 2021-2022, we think that the sector will expand against the backdrop of continued standardization and integration. Over the next 12 months, we could see progress on a unified global legal and regulatory framework for Islamic finance that the Dubai Islamic Economy Development Center (DIEDC) and its partners are developing. Depending on the outcome and its adoption, we believe that such a framework could help resolve the lack of standardization and harmonization that the Islamic finance industry has faced for decades.

We may also see more frequent issuance of dedicated social Islamic finance instruments and green sukuk as the industry leverages its alignment with environmental, social, and governance (ESG) values. This would help tackle the aftermath of the pandemic and support the agenda for core countries' energy transition. We expect such processes will remain slow, however, given the additional complexity related to these instruments and the core Islamic finance countries' slow implementation of policies to manage the energy transition.

**Chart 1 - A \$2.2 Trillion Industry That Will Continue To Expand...**



Source: Central Banks, IFSB, Eikon, S&P Global Ratings  
Copyright © 2021 by Standard & Poor's Financial Services LLC. All rights reserved.

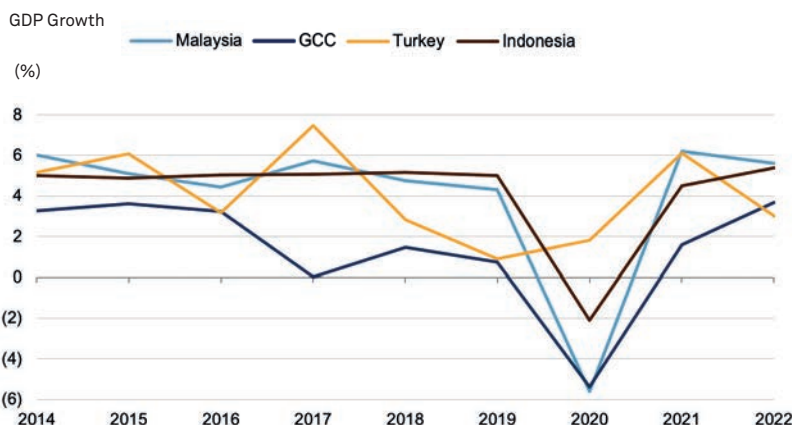
## Growth In 2020 Slowed To About 10%, And This Level Of Growth Will Likely Continue In 2021

The Islamic finance industry continued to grow in 2020, although more slowly than in 2019. The industry's assets expanded by 10.6% in 2020 versus 17.3% in 2019 when growth was supported by higher-than-expected sukuk issuance (see chart 1).

### We now believe that the industry will continue to expand by 10%-12% in 2021-2022.

- We expect economic recovery in core Islamic finance countries, although some countries' GDP growth will be lower than what we have observed historically (see chart 2).
- We expect financing growth in Saudi Arabia to remain strong, fueled by mortgages and by corporate lending as the country implements some of its Vision 2030 projects. We also expect some growth in Qatar supported by investments related to the upcoming World Cup, and to a lesser extent the United Arab Emirates (UAE) where the Dubai Expo is likely to help boost economic activity. Malaysia and Turkey will also continue to grow, although Turkey's growth will be at a slower pace and driven primarily by public sector participation banks.
- On the sukuk front, S&P Global Ratings forecasts total sukuk issuance of about \$140 billion–\$155 billion this year. This compares with a drop in issuance to \$139.8 billion in 2020 from \$167.3 billion in 2019. We expect an increase in the volume of issuances this year as liquidity remains abundant, corporates and sovereigns come back to the market, and new issuances exceed maturing sukuk. In the first quarter of 2021, issuance volumes were up by 1.4% in total and 22% if Sukuk re-openings (issuances under existing structures) are excluded. The additional challenges related to compliance with Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standards in the GCC has slowed some issuers, though.
- Although their contribution to the industry remains small, we also expect the takaful and the fund sector to grow this year. We continue to see the takaful sector expanding at 5%-10%, while the funds industry might see some growth as investors chase yields.

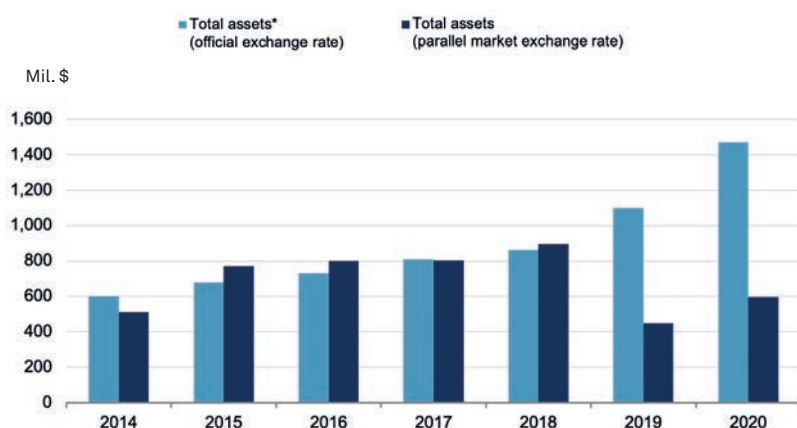
**Chart 2 - ...Helped By The Recovery In Core Markets And Volume Of Sukuk Issuances**



GCC--Gulf Cooperation Council.

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**Chart 3 - Impact Of Foreign Currency Exchange Rate On Total Assets Of Banks And Nonbank Credit Institutions In Iran**



\*Assets of banks and nonbanks credit institutions. Source: Central Bank of Iran.

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**Downside risks exist, however, chief of which is the COVID-19 pandemic and whether it will be brought under control.**

S&P Global Ratings believes there remains high, albeit moderating, uncertainty about the evolution of the coronavirus pandemic and its economic effects. Vaccine production is ramping up and rollouts are gathering pace around the world. Widespread immunization, which will help pave the way for a return to more normal levels of social and economic activity, looks to be achievable by most developed economies by the end of the third quarter. However, some emerging markets may only be able to achieve widespread immunization by year-end or later. We use these assumptions about vaccine timing in assessing the economic and credit implications associated with the pandemic (see our research here: [www.spglobal.com/ratings](http://www.spglobal.com/ratings)). As the situation evolves, we will update our assumptions and estimates accordingly.

Overall, we believe a 10%-12% growth rate for the industry (excluding Iran) over the next two years is achievable. The pandemic offered the possibility of a more broad-based and transformative growth, but the industry has yet to fully unlock opportunities related to standardization and increase its contribution to sustainable finance. Coordination between the different stakeholders will be a key factor of success to leverage the opportunities related to the energy transition for core Islamic finance countries and its social angle.

### Why Did We Exclude Iran From The Calculation Of The Industry Assets?

The country's currency has reportedly declined significantly in value versus the U.S. dollar, even though the official exchange rate remains fixed. This results in about \$900 billion valuation discrepancy. Using the official exchange rate, the figures reported by the Central Bank of Iran (CBI) show total assets of the banking system (including nonbank institutions) at \$1.47 trillion as of Feb. 7, 2021. However, the parallel rate as reported by the CBI for 2018-2019, and assuming it has not changed despite market sources pointing to a depreciation, shows a total asset of \$598 billion at Feb. 7, 2021 (see chart 3). Therefore, given the potential disruptive impact of these numbers on the overall credit story of the industry, we excluded them for this year.

## The Social Angle Of Islamic Finance Is Not Sufficiently Visible

COVID-19 has caused a significant slowdown in core Islamic finance markets and a spike in unemployment. While the Gulf's predominantly migrant population structure has led to population shrinkage, and some governments' support packages have helped to absorb some of the shock, several stakeholders have lost a portion of their income.

There are dedicated Islamic finance social instruments. However, their use has remained somewhat less visible in the current environment. We have seen a handful of social sukuk issuances. The Islamic Development Bank (IDB) issued a \$1.5 billion sustainable sukuk in 2020 and another \$2.5 billion one in 2021. The IDB disclosed that the proceeds of the second sukuk will be used to finance green (10%) and social development projects (90%). This sukuk was allocated predominantly to Middle East and North Africa investors (around 60%) and central banks and official institutions (78%).

Malaysia issued its "Prihatin" sukuk, which is akin to a war bond. This sukuk has a low periodic distribution rate payable to the investors, and the government used the proceeds to help restart the economy. More recently, Malaysia has also issued a \$1.3 billion sukuk, including a sustainability tranche. The sukuk was 6.4x oversubscribed. The proceeds will reportedly be used to fund social and environmental projects as part of the government's agenda to fight climate change and build a more sustainable and inclusive economy.

These and other Islamic finance instruments could help make an even bigger impact if they are leveraged properly. Moreover, these types of innovative instruments targeting social needs may appeal to other local or foreign investors with ESG objectives. They show that the pandemic has presented an opportunity to put the social element back into Islamic finance and demonstrate the social aspect of the Sharia goals, Maqasid. We expect to see more of these instruments in the medium term.

Green sukuk is another area of opportunity, owing to the energy transition, in line with the developing green agenda in many core Islamic finance countries. As with social sukuk, although we expect to see some activity around green sukuk, we don't see it as a game changer. We expect the energy transition will take a long time to materialize in the GCC and Malaysia, and as such, expect to see sporadic recourse to green sukuk. It remains to be seen if greater standardization of these instruments or their greater contribution to economic recovery will accelerate their development.

## Will Inclusive Standardization Eventually Happen?

In 2020, unlike what some market participants expected, the overall volume of sukuk issuance dropped to \$139.8 billion from \$167.3 billion in 2019. That's despite the sharp drop in the oil price and the significant increase in financing needs of core Islamic finance countries. These issuers have instead tapped the conventional markets, where it is easier and quicker to get the funds.

Sukuk instruments remain more complex and time consuming for issuers than conventional bonds. What's more, some jurisdictions' adoption of AAOIFI standards, has already caused some difficulties for sukuk issuers in early 2021, particularly those with hybrid structures that combine a commodity murabaha with tangible assets. In the past, the tangibility ratios of these structures were complied with on a best-efforts basis once the transactions were issued. With the adoption of the AAOIFI standards, compliance became an obligation throughout the lifetime of the transaction. The challenge issuers are facing is how to implement AAOIFI standards without changing the credit characteristics of the transaction.

There are indeed several risks related to obligation of compliance with the tangibility ratio throughout the lifetime of the transaction. One of the risks pertains to the reasons for a potential noncompliance and if it is related to a partial loss, for example of the underlying assets. This returns investors' exposure to the residual asset risks that were in the past mitigated by the restriction of the exposure to a total loss scenario. The risk of having one asset destroyed is certainly higher than having several destroyed at the same time.

The second risk is related to prepayments on some assets and if the issuer does not have sufficient unencumbered assets. This risk is more relevant for corporates (and mainly smaller ones) and would make access to sukuk even more difficult for them.

Another risk is related to dissolution of the transaction before its maturity if the tangibility ratio is not respected, which is one of the strategies implemented by issuers to comply with this requirement. Here again, corporates might face a higher risk of default because some of their debt might suddenly become immediately repayable. This raises the necessity of a critical review of some of the existing standards, and the adoption of an inclusive approach taking on board the views of all the stakeholders. The process would ultimately lead to the standardization of the full spectrum of sukuk (from fixed-income-like instruments to equity-like ones) factoring the requirements of regulators, sukuk issuers, and investors.



Standardization here includes both aspects of sukuk: sharia interpretation and legal documentation. It is when sukuk issuance becomes comparable with conventional instruments from a cost and effort perspective that it will find a prominent place on the radar for issuers and investors.

### More Defaults To Come

Some corporates will also suffer from the current economic environment. However, this risk has not yet fully materialized on banks' balance sheets because of the regulatory forbearance and liquidity support measures implemented in many countries. The extension of these measures in most countries has further delayed the materialization of credit risk. We believe these extensions have likely delayed an increase in default rates among corporates and potentially of sukuk issuers in the next 12 months, especially those with low credit quality or business plans that depend on supportive economies and market conditions. We see pressure on real estate developers, given the drop in real estate prices in the GCC and building risks in the commercial real estate sector. Similarly, companies related to aviation, tourism, travel, and hospitality--sectors that have been severely hit by COVID-19--will take several quarters to recover to prepandemic levels.

We have already seen some sukuk restructurings in 2020, such as by PT Garuda Indonesia, which extended the maturity of its sukuk by three years after getting the approval of more than 90% of the sukuk holders. We expect to see more requests for extensions or restructurings among sukuk issuers in 2021, along with higher default rates. These instances will test the robustness of the legal documentation used for sukuk issuance and could strengthen the case for the documentation to be standardized. Defaults will also test the robustness of the insolvency regimes, which some core Islamic finance countries have strengthened recently, including countries in the GCC. If investors can get clarity on their financial recourse mechanisms because of these events, this would probably outweigh the negative impact on market sentiment.

### A Unified Global Legal And Regulatory Framework Is Being Created

Over the next 12 months, we expect some progress on the unified global legal and regulatory framework for Islamic finance that the DIEDC and its partners are developing. DIEDC embarked on this project with the Islamic Development Bank, the United Arab Emirates Ministry of Finance, and several other advisors in 2020.

The project's stated objectives include providing a global legal benchmark for Islamic finance, reducing regional differences in product offerings and practices, providing legal protection to all parties involved, and developing an international dispute resolution framework.

Depending on the outcome of the project, issuers may benefit from a speedier and more streamlined process to tap the Islamic finance market. Investors may also gain greater clarity on sukuk resolution in the case of default. This could make the industry more attractive to new players.

### Fintech Will Enhance The Industry's Resilience

COVID-19 has 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 more volatile environments and open new avenues for growth. The industry is partially there, and digitalization is now taking a prominent place among decisionmakers' priorities. Getting banking services digitally, issuing sukuk on a digital platform using blockchain technology, and enhancing cyber security will be the three main factors that would help the resilience of the industry.

A prerequisite for fintech's ability to enrich the Islamic finance industry is the provision of an adequate physical infrastructure and the implementation of the necessary supervision and regulatory framework. That is why several regulators and authorities in the GCC and elsewhere have launched incubators or specific regulatory sandboxes where fintech companies can test innovations.

### Related Research

- Islamic Finance In Turkey: Capital Availability Is Likely To Constrain Growth In Coming Years, May 3, 2021
- Global Sukuk Issuance Is Set To Increase In 2021, Jan. 12, 2021
- 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

*This report does not constitute a rating action.*

# The Global Sukuk Market Is Returning To Traditional Risks

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**S** &P Global Ratings believes that market conditions will remain supportive for sukuk issuance in second-half 2021, with low interest rates and abundant liquidity. We also expect that most Islamic finance countries will continue vaccinating their populations and that oil prices will stabilize at about \$65 per barrel for 2021. Taken together, these factors point to stronger sukuk market performance in 2021 compared with 2020.

## Key Takeaways

- In first-half 2021, sukuk issuance volumes increased 5% (20% including primary issuances only) due to strong liquidity, low interest rates, and some issuers returning to the market.
- The market is now exposed to more traditional risks such as oil price volatility, geopolitical concerns, or a shift in global liquidity conditions, assuming pandemic-related disruption remains contained in core Islamic finance countries.
- The adoption of the Accounting and Auditing Organization for Islamic Financial Institutions' (AAOIFI's) Sharia Standard 59 in the United Arab Emirates (UAE) has depressed sukuk issuance in the country and increased investors' exposure to residual asset risks.

We expect sukuk issuance will reach \$140 billion-\$155 billion in 2021, compared with \$139.8 billion in 2020. In first-half 2021, sukuk issuance totaled \$90.6 billion, compared with \$86.4 billion at June 30, 2020, thanks to Malaysian and Saudi Arabian issuances. By contrast, we saw a 50% drop in sukuk issuance in the UAE due to the adoption of AAOIFI Sharia Standard 59. Although issuers have found ways to comply with the standard, additional challenges persist. In our view, investors are also now more exposed to residual asset risks.

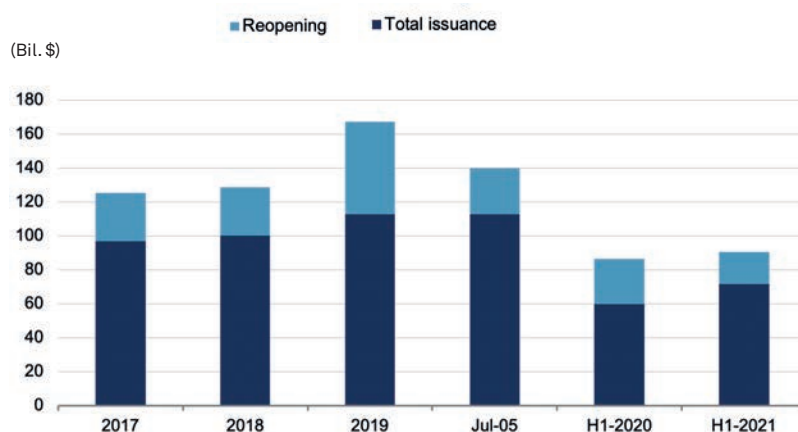
More broadly, downside risks for the sukuk market remain but they are slowly shifting toward traditional factors such as geopolitical concerns and oil price fluctuations. Notably, the evolution of the pandemic also remains a relevant concern.

In first-half 2021, we saw three sustainability sukuk issuances. The post-pandemic environment, energy transition from fossil fuels, and general attractiveness of these instruments to environmental, social, and governance (ESG) investors explain their appeal. Nevertheless, we expect that sustainability sukuk will remain a small part of overall sukuk issuance volumes due to their complexity and the slow implementation of policies to manage energy transition in core Islamic finance countries.

### Sukuk Issuance Will Continue To Increase

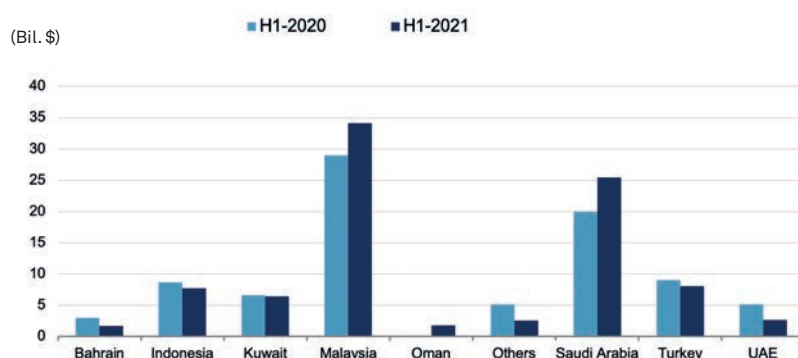
Absent an unexpected geopolitical event, a significant drop in oil prices, or a shift in liquidity conditions on global capital markets, we expect sukuk issuance will continue to rise. In first-half 2021, total issuance reached \$90.6 billion compared with \$86.4 billion during first-half 2020 (see chart 1). This performance was supported by an increase in issuance from Malaysia and Saudi Arabia and Oman's return to the market after issuing conventional debt in 2020 (see chart 2). It was also supported by a higher volume of primary issuances, increasing 20%. At the same time, the volume of issuance in Bahrain, Indonesia, Turkey, and the UAE declined. In Turkey, the decline was mainly for local currency denominated issuances. Meanwhile, the UAE saw the steepest decline with a 50% drop in issuance volumes due to the adoption of Sharia Standard 59. We expect some activity from UAE issuers as they implement the new requirements.

**Chart 1 - Sukuk Issuance Will Continue To Increase**



Source: S&P Global Ratings, Eikon. H1--First half.  
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**Chart 2 - A Few Countries Have Contributed To This Increase**



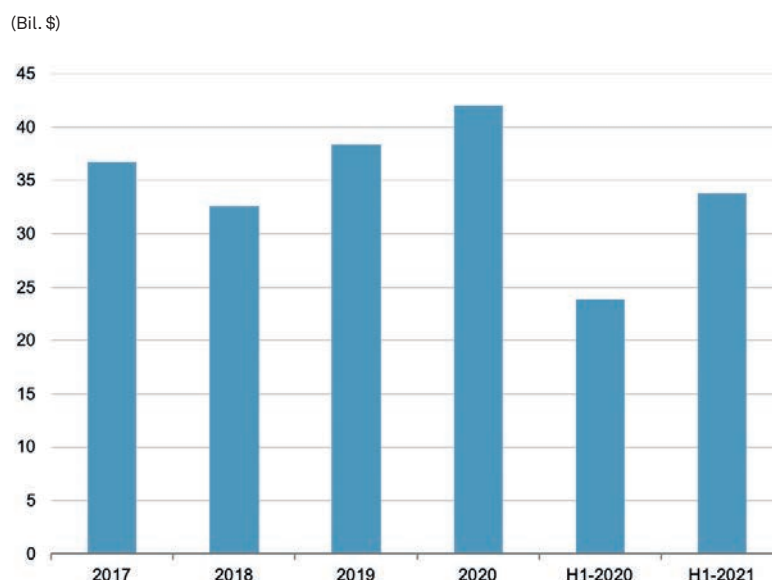
Source: S&P Global Ratings, Eikon. H1--First half.  
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Despite higher oil prices and lower fiscal deficits, we expect that some sovereigns in the Gulf Cooperation Council will continue to tap the market to fund their economic diversification programs. We also expect that bank and corporate issuances will continue to support sukuk market performance in second-half 2021. Corporate activity was muted in 2020 as companies held on to cash during the heights of the pandemic and deferred capital expenditure. A portion of these investments are expected to be executed in 2021 and will necessitate access to capital markets. Furthermore, there are about \$20 billion of sukuk maturing in second-half 2021, some of which are likely to be refinanced on the market.

Foreign-currency denominated sukuk issuance increased 41.6% in first-half 2021 (see chart 3). We attribute this growth to jumbo issuances but also favorable market conditions, which we expect will continue in second-half 2021.

**Chart 3 – Foreign Currency Issuances Continued To Increase**



Source: S&P Global Ratings, Eikon. H1--First half.  
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## Sharia Standard 59 Creates New Risks

AAOIFI Sharia Standard 59, which covers the sale of debt, has reportedly depressed sukuk issuances in the UAE. The standard was finalized by AAOIFI in December 2018 and came into force in the UAE starting this year. It has depressed hybrid sukuk issuance in part because it altered the requirements around an important transaction feature necessary for shariah compliance, the tangibility ratio. Many hybrid sukuk are structured around a combination of tangible assets and commodities. Before the adoption of the standard, an issuer was required to have a minimum ratio of 51% tangible assets and a maximum of 49% commodities at the inception of the transaction. The maintenance of this ratio, throughout the lifetime of the transaction, was on a best-effort basis and remedial actions in case of a breach were unclear. With the adoption of Sharia Standard 59, the maintenance of a 51% tangibility ratio becomes a legal requirement throughout the transaction's lifetime and the remedies for a breach must be clarified.

As such, some of the most recent legal documents for hybrid sukuk issued in the UAE, or by issuers that would like to attract UAE investors (subject to AAOIFI standards), included an obligation to maintain the ratio throughout the sukuk's lifetime and new clauses to clarify remedial actions. Mostly, these consisted of an obligation to restore the tangibility ratio as and when suggested by the issuer's Sharia advisor, should the ratio fall below 50% but remain above 33%. If the ratio falls below 33%, we observe that issuers generally have the obligation to delist the sukuk and provide holders the option to request early dissolution. In our view, compliance with Sharia Standard 59 creates or amplifies three primary risks.

**Exposure to residual asset risk:** This was already present through total loss event risks. However, for some structures, the risk is increasing as a partial loss event also becomes relevant. Indeed, in a transaction with several assets, if one or more are destroyed, the tangibility ratio could be breached, and investors may not be fully reimbursed for their investment. Partial loss is generally covered through the obligation to ensure the underlying assets for the value of the asset and a certain amount to cover the income lost if the asset is destroyed. The insurance proceeds also have to be paid within a specific time (several days after the partial loss occurs).

In our view, the insurance conditions imposed on the issuer are very restrictive, which could make insurance extremely difficult to obtain. Therefore, investors may lose some of their investments if a partial loss event occurs and would have no recourse to the sponsor, which could demonstrate that it tried to insure the asset but, as defined in the legal documents, the risks were not insurable. We do not rate sukuk transactions based on their insurance coverage. We would instead assess the remoteness of total or partial loss events and rate to that assumption.

### ***Changing investor ranking in a liquidation scenario:***

Standard 59 also affects the language related to the indemnity typically offered by the sponsor of the sukuk as an independent entity, in case it fails any of its contractual obligations. These usually include the obligations to pay rent or buy back the rights, benefits, or entitlement to the underlying assets. In a liquidation scenario, these could be perceived as nonfinancial obligations and, as such, rank after the financial obligations of the sponsor, making the sukuk creditors akin to subordinated creditors. Existing indemnity language resolved this issue by creating additional financial obligations for the sponsor (as an independent entity from the transaction). However, since this would be considered debt from a sharia perspective, it is no longer acceptable under Standard 59. In some instances, lawyers have resolved this issue by requiring that the sponsor maintains the benefit, custody, or actual or constructive possession of the underlying assets the entire time, so it can execute this indemnity. We do not rate sukuk to this indemnity, but we rate to the contractual obligations of the sponsor. This means that if the sponsor fails to comply with these obligations, the rating may be lowered to the default category.

### ***Increasing liquidity risk for issuers and investors:***

Compliance with Standard 59 creates new potential scenarios for early sukuk dissolution. If the issuer has insufficient unencumbered assets on its balance sheet, if there is prepayment risk for the underlying assets, or in a partial loss event, there could be sukuk acceleration and repayment before the maturity. For some issuers, this could be problematic, since it requires liquidity planning. Ultimately, corporates may face a higher risk of default because some of their debt might suddenly become immediately repayable. Such risks would be reflected in our liquidity analysis of the corporate.

Overall, this could mean more difficulty in accessing the sukuk market and lower investor appetite for the instrument. Sukuk instruments are already more complex and time consuming for issuers and investors than conventional bonds. This makes a critical review of some of the existing standards, and the adoption of an inclusive

approach considering the views of all stakeholders, a necessity. The process would ultimately lead to the standardization of the full spectrum of sukuk (from fixed-income-like instruments to equity-like ones) factoring the requirements of regulators, sukuk issuers, and investors. Some market participants believe that standardization is not achievable. However, in our view, it is not only achievable but would unlock growth opportunities for the industry.

Standardization includes both aspects of sukuk: sharia interpretation and legal documentation. When a sukuk issuance becomes comparable with a conventional issuance from a cost and effort perspective, it will become a more prominent consideration for issuers and investors. Over the next 12 months, we expect some progress on the unified global, legal, and regulatory framework for Islamic finance that Dubai and its partners are developing. Depending on the outcome and adoption, issuers may benefit from a speedier and more streamlined process to tap the Islamic finance market. Investors may also gain greater clarity on sukuk resolution in the case of default. This could make the industry more attractive to new players.

## **Social And Green Issuance Volumes Are Likely To Remain Limited**

Over the past six months, we have observed a few sustainability sukuk issuances. The Islamic Development Bank issued a \$2.5 billion sukuk and disclosed that the proceeds will be used to finance green (10%) and social development projects (90%). Malaysia also issued a \$1.3 billion sukuk, including an \$800 million sustainability tranche, which was 6.4x oversubscribed. The proceeds will reportedly be used to finance social and green projects aligned to the U.N.'s Sustainable Development Goals. Furthermore, Indonesia issued a \$750 million green tranche as part of its \$3 billion issue in first-half 2021. Although these types of instruments may appeal to investors with ESG objectives, and we expect to see more of them, we think that they will be the exception rather than the norm.

Similarly, green sukuk is another area where opportunities are reportedly high, given the energy transition in many core Islamic finance countries and ambitions of some in the electric vehicle space. However, the additional complexity of green sukuk and the slow implementation of the energy transition agenda suggest that market dynamics will not change in the next one-to-two years.

## Related Research

- External Auditing Of Sharia Compliance Will Likely Strengthen Governance In Islamic Finance, May 24, 2021
- Islamic Finance Is Still Finding Its Feet In North Africa, May 12, 2021
- Vision 2030 Will Push Forward Saudi Arabia's Debt Capital Market, May 4, 2021
- Islamic Finance In Turkey: Capital Availability Is Likely To Constrain Growth In Coming Years, May 3, 2021
- Islamic Finance 2021-2022: Toward Sustainable Growth, May 3, 2021
- Global Sukuk Issuance Is Set To Increase In 2021, Jan. 12, 2021

*This report does not constitute a rating action.*



# Vision 2030 Will Push Forward Saudi Arabia's Debt Capital Market

To finance Vision 2030, Saudi Arabia's plan to transform and diversify its economy and grow the private sector, authorities aim to deepen their debt and equity markets to increase foreign direct investment. The strategy also entails investments by the government and its related entities as well as the private sector of about Saudi Arabian riyal (SAR) 12 trillion (\$3.2 trillion) by 2030. However, one question is, where will the funds come from? While S&P Global Ratings thinks banks will continue to play an important role in financing Vision 2030, we foresee an increased role for the local capital market. What's more, we understand that an increased amount of the funding will be pushed off the central government and onto the balance sheets of government-related entities and broader private sector.

## Key Takeaways

- Saudi authorities are continuing to further develop their debt and equity markets and increase foreign direct investment in the country.
- Driving growth of the country's debt market will be an increase in issuance to help fund the SAR12 trillion (\$3.2 trillion) Vision 2030.
- Also favoring growth of the Saudi debt market are lending limits that Saudi banks will face as borrowing needs grow.
- The Saudi riyal's peg to the U.S. dollar will continue to provide comfort to foreign investors.
- We view development of Saudi debt markets as broadly supportive of the credit profiles of the country's banks and corporates over the long term.

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While the U.S. dollar will continue to be the currency of choice for issuance in Saudi Arabia, we expect to see gradually greater use of Saudi Arabian riyal-denominated issuance as the local market develops. The currency peg between the U.S. dollar and the riyal, which we expect will remain, could help attract foreign investors actively hunting for yield in an environment of low interest rates. A gradual deepening of the local capital market would likely increase levels of transparency and could reinforce governance practices in Saudi Arabia in coming years.

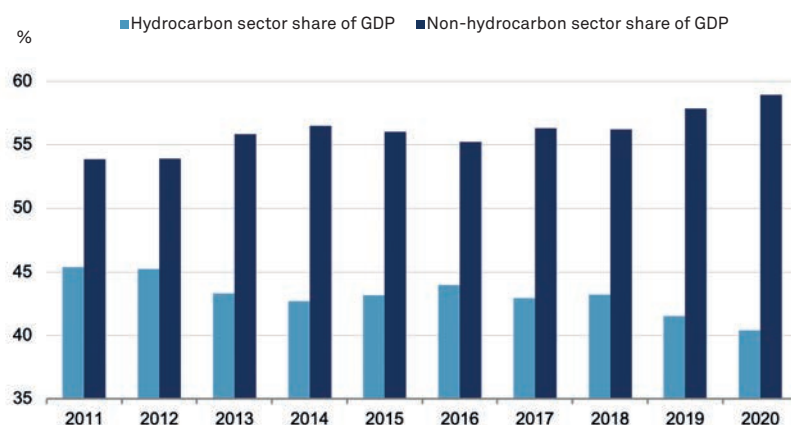
## The Largest Non-Oil Economy In The GCC Is Transforming

Saudi Arabia is a Group of 20 (G-20) country, given that it is one of the world's largest economies, with GDP of about \$700 billion at year-end 2020, and is the world's largest oil exporter. Of the Gulf Cooperation Council members, it has the largest population of about 33 million--60% of which are local nationals--at year-end 2020.

Given the size of the local population and their requirements for goods and services, the country also has a sizable non-oil economy (see chart 1). In addition to its extractive industries, it has a large and growing manufacturing base, transportation sector, construction, as well as a large consumption sector that hosts many different business operators.

Nevertheless, the hydrocarbon sector accounts for about 40% of real GDP. This dependence carries risks in coming years as the world moves toward cleaner energy. With that in mind and to reduce the impact of the volatile oil market on the economy, Saudi authorities embarked on an ambitious plan, Vision 2030, to transform the country and diversify away from oil. The plan targets change in several key sectors including health, education, tourism, infrastructure, renewables, manufacturing, and defense—and development of the financial sector. Indeed, the strategy will require a large amount of financial resources over the next decade, which Saudi Arabia hopes to raise via capital markets, among other sources.

**Chart 1 - Saudi Arabia's Contribution Of The Non-Hydrocarbon Sector To GDP Has Grown, 2011-2020**



Note: GDP at constant prices. The difference between the sum of the hydrocarbon and non-hydrocarbon sectors and 100% is due to the exclusion of import duties. Source: S&P Global Ratings. Copyright © 2021 by Standard & Poor's Financial Services LLC. All rights reserved.

## The Capital Markets: Under Construction

Over the past decade, the Capital Markets Authority (CMA), the country's capital markets regulator, has undertaken several measures to develop its equity and debt capital markets and attract foreign investors.

For example, over the past few years, there were several initiatives to improve the infrastructure and trading rules of Tadawul, the country's stock exchange, to increase market access for investors. This paved the way for Saudi Arabian stocks to be included in the MSCI Emerging Markets Index in 2019 and FTSE Russell and S&P Dow Jones indices subsequently, further increasing the visibility of Saudi equities to global investors. Similarly, in 2020, the CMA started allowing nonresident foreigners to invest directly in listed and nonlisted debt instruments. We have also seen a visible increase in listed debt issuances by Saudi corporates, particularly government-related entities, which represented about 90% of the about \$26 billion listed corporate bond and sukuk issuance in 2019 and 2020.

## Low Oil Prices And High Deficits Pushed The Government To Borrow

When oil prices dropped sharply beginning in the second half of 2014, the Saudi government balance fell into deficit, requiring a broadening of its funding options and a move away from depleting its assets. As a result, the Saudi Debt Management Office was set up in 2015, and between 2015 and 2020 the government issued over \$200 billion of bonds and sukuk. As a result, debt outstanding has increased sharply (see chart 2). We forecast that gross debt will rise to about 46% of GDP by 2023, up from 20% in 2019 and close to zero in 2014. In March 2020, the government increased its debt ceiling to 50% of GDP from 30%, to accommodate further borrowing. We expect the sovereign to remain an active issuer over the next few years based on our projections of increasing but moderating fiscal deficits.

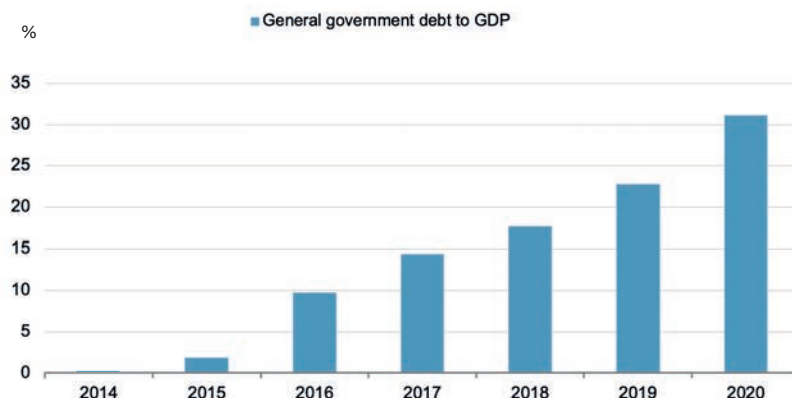
Nevertheless, nonsovereign debt capital markets in Saudi Arabia remain underdeveloped relative to other key markets globally. We estimate that the total value of bonds and sukuk outstanding that Saudi banks and corporates have issued as of May 2, 2021, is slightly lower than 10% of the country's GDP at end-2020. In comparison, we estimate this ratio at about 25% for Brazil, Russia, and India, and about 50% for the top 20 largest economies of the world, based on Bloomberg data. Furthermore, when we look only at the local currency portion of the outstanding issuance for Saudi Arabia, this ratio is even lower at about 3%. We expect to see a visible increase in this ratio in line with the country's planned investments and financing needs.

## Implementation Of Vision 2030 Will Require An Increase In Debt Issuance

Over the next few years, we expect the government to allocate part of spending to a series of large projects under Vision 2030 and away from the oil sector. The Public Investment Fund (PIF) will play a particular role in supporting and funding a certain level of capital expenditure to create direct and indirect jobs through investments in 13 strategic sectors including aerospace and defense, tourism and entertainment, health care, renewables, mining, and transportation.

Reportedly, 24 of the country's largest companies--mostly government-related entities like Saudi Aramco (unrated) and SABIC (A-/Stable/A-2)--plan to invest about SAR5 trillion (\$1.3 trillion) in a number of projects, while PIF

**Chart 2 - Saudi Arabia: Evolution Of Government Debt, 2014-2020**  
Significant issuance since oil price declines in second-half 2014



Source: S&P Global Ratings.  
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reportedly will inject SAR3 trillion. The remaining SAR4 trillion will be injected under a new national investment strategy program. This will come on top of the SAR10 trillion in government spending the authorities have already budgeted.

Given the sheer size and the long-term nature of investments under the 2030 program, the banking sector alone will be unable to fill the need. While it remains liquid, well-funded, and strongly capitalized, the banking system is subject to concentration risk regulations and constraints regarding maturity transformation (borrowing money on shorter timeframes than on lending). We therefore expect a significant portion of the funds to come from the capital market, leading to a progressive rebalancing of the country's financial system and development of a broader local capital market.

## Investors Have Saudi Arabia On Their Radar

Greater issuance by the Saudi sovereign will attract more attention from investors, particularly given their search for higher-yielding investments in an era of low interest rates. On the corporate debt market, we expect large government-related entities to be the main issuers at first, followed by a few top corporates, rather than a general movement to the capital markets.

In addition, we believe the market will gradually see more issuance denominated in Saudi riyal, though U.S.-dollar denominated issuance will remain prevalent. To that end, Saudi authorities have taken the initiative to create a local currency benchmark rate through sovereign issuance and have increased the volume of riyal-denominated issuance from key government-related entities. In addition, Saudi authorities continue to work on initiatives to further develop the infrastructure for the country's debt capital markets. We believe the peg between the U.S. dollar and the riyal is a comfort factor for foreign investors.

Saudi Arabia's energy transition and transformation of its economy to a more sustainable one should also improve Saudi issuers' standing in terms of environmental, social, and governance (ESG) considerations. We expect to see a higher volume of sustainable funding in the next few years to finance the needs created by Vision 2030. We also think that greater involvement by foreign investors will likely strengthen corporate governance practices in the country.

### Corporate And Bank Credit Quality Could Benefit

The underdevelopment of the Saudi capital market limits monetary policy transmission. The government started issuing local currency debt and sukuk in 2015, and we expect this to continue over the next few years. We believe government debt issuance can be instrumental in addressing the absence of a benchmark yield curve and contribute to the development of the debt capital market. Private-sector issuance could follow suit, in a move away from purely benchmark transactions to more systematic use of debt issuance in the funding mix. Like elsewhere in the GCC, nonfinancial corporates in Saudi Arabia fund themselves largely through the country's local banks through instruments that are largely short term in nature. We believe more frequent use of the capital markets will allow Saudi corporates to further diversify their funding sources, access a larger variety of local and international investors, and give them the capacity to extend their funding maturity profiles. We would view all these developments as supportive factors for the credit profiles of Saudi corporates.

The availability of a well-functioning domestic debt capital market can also help the Saudi banking system's funding options. Most funding comes from core customer deposits, a large portion being short term or on demand. As credit continues to grow, the banking system could benefit from longer-term funding sources on the local market, which we view as more stable than cross-border funding. We note that the banking sector still displays an overall net surplus

external asset position despite a rapid buildup of external debt on the back of softer monetary policy globally. The presence of a deeper and broader capital local market could be positive for our view of the funding profile of Saudi banking system as a whole.

Editor: Rose Marie Burke.

### Related Research

- Research Update: Saudi Arabia 'A-/A-2' Ratings Affirmed; Outlook Stable, March 27, 2021
- Corporate Governance Practices In The GCC, March 15, 2021
- SLIDES Published: Saudi Arabia Banking Sector 2021 Outlook: Growth Hinges On Mortgage Lending And Public Spending, Feb. 23, 2021
- Expat Exodus Adds To Gulf Region's Economic Diversification Challenges, Feb. 15, 2021
- GCC Corporate And Infrastructure Outlook 2021: Proceeding With Caution, Feb. 2, 2021
- Banking Industry Country Risk Assessment: Saudi Arabia, Oct. 13, 2020

*This report does not constitute a rating action.*



# Can Islamic Banks Maintain Strong Growth In Southeast Asia?

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**C** OVID-19 has not derailed the general trajectory for Islamic banks in Southeast Asia. S&P Global Ratings believes the segment will continue to grow faster than conventional banks. These banks benefit from government support, large Muslim population in many countries in the region, and strong demand for Sharia-compliant financial products. Additional benefits include increased standardization of contracts, and potential unification of global legal and regulatory framework for Islamic finance.

Nevertheless, these institutions, like conventional banks, have seen disruptions due to the pandemic. Amid new waves of infection, Islamic bank growth rates will likely moderate and asset quality stress persist for longer.

High levels of forbearance for both conventional and Islamic banks mask the true extent of weak loans in these emerging markets. Temporary relief measures will aid stressed borrowers, though recognition of problem loans will be delayed. This has potentially masked asset quality problems and understated the impact on earnings and capital.

In addition, the abrupt business and operational disruptions brought by the pandemic have forced a rapid change of mindset and strategies of Islamic lenders, which are looking more actively at digitalizing their offerings and leveraging more on fintech partnerships and outsourcing.

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## Frequently Asked Questions

### Which countries are seeing the fastest momentum for Islamic finance?

Malaysia and Indonesia's Islamic banks will, in our view, continue to expand loan books faster than for conventional banks. In Brunei, Islamic finance has a significant share already and will likely keep pace with sector-average growth.

### *Malaysia: Islamic banks will outpace sector growth.*

Islamic banks have been the key driving force of credit expansion among Malaysian banks in the past decade, and this trend should continue despite COVID. We project the overall banking sector will increase loans this year by 4%. This rate is likely to be more than double for Islamic banks (i.e., 10% or more).

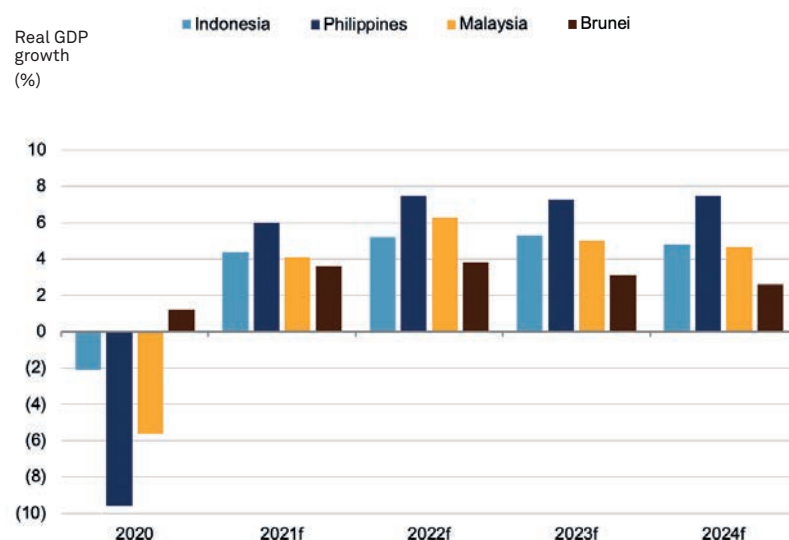
Sharia-compliant banks have been consistently gaining market share, controlling more than 36% of the banks' assets at year-end 2020 (see chart 2). Growth will be driven by household credits, where market demand remains resilient. This includes demand for residential mortgages given the extension of the Home Ownership Campaign deadline and instalment-plan purchases of goods. We see lower levels of growth for personal loans and credit cards, because of the higher credit risk.

### *Indonesia: Penetration to gain momentum with Bank Syariah merger.*

We believe the merger of the Islamic finance subsidiaries of state-owned banks earlier this year is positive for Indonesia's Sharia banking sector. It is also in line with the Indonesian government's plan to promote Sharia-compliant financing by creating a strong Islamic bank.

The merged entity, Bank Syariah Indonesia (BSI), is the seventh-largest lender in the country with assets of about US\$15 billion. This represents a domestic market share of about 2.5%. The merged bank will benefit from economies of scale and improved ability to raise funds at competitive rates. It can leverage on the wide reach of its three major stakeholder banks and will be well positioned to grow considering Indonesia's large Muslim population. Associated revenue and cost synergies could lift profitability over the next three to five years.

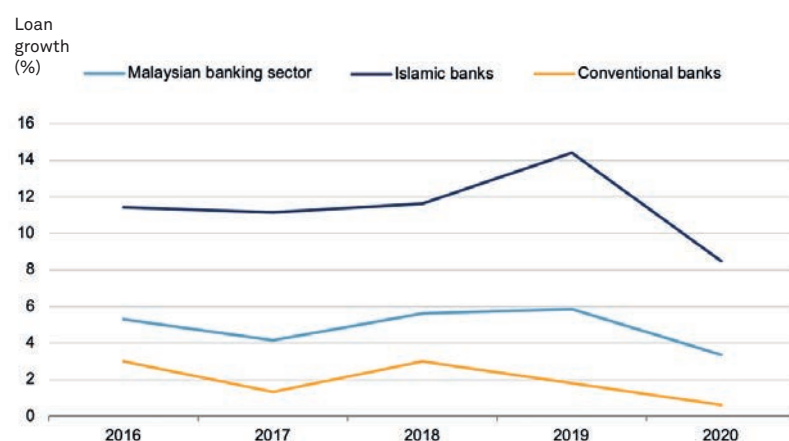
Chart 1 - Gradual Economic Recovery In Southeast Asia



f--Forecast. Source: S&P Global Ratings.

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Chart 2 - Malaysian Islamic Banks Consistently Growing Faster Than The Industry



Source: S&P Global Ratings.

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Islamic banks should continue to grow faster than conventional banks, given ample opportunities in Indonesia and low penetration. Sharia-compliant banks and business units hold a small 6% market share in Indonesia. This market share should continue to improve even though profitability will remain lower than for conventional banks, at least for small and midsized banks. This mainly reflects their lower cost efficiency relative to conventional banks (see chart 3).

#### **Brunei: Islamic banks have high market share.**

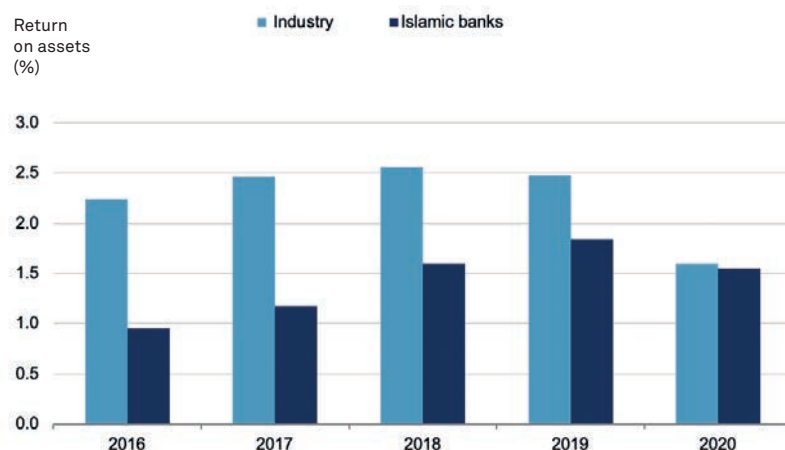
Islamic financial institutions constitute around half of the total financial system assets in the hydrocarbon-dominated economy of Brunei. We expect performance of these institutions to mirror that of the broader banking system. According to our forecasts, Brunei's economic growth will accelerate to above 3% in the next two years. This will be supported by stronger energy prices, recovering external demand, the country's continued success in controlling the pandemic, and sustained buoyancy in the petrochemical sector.

We anticipate overall bank credit growth will be 3%-5% in the next 12-18 months. The bulk of the expansion is likely to come from wholesale customers as the government looks to boost the economy and support local firms through contracts from government-linked companies, foreign direct investment projects, the oil and gas sector, and infrastructure development. Retail activity could remain constrained by regulations on the total debt service ratio (TDSR) and the saturated market.

#### **Philippines: State-owned Islamic bank likely to remain the sole Sharia specialist over the next few years.**

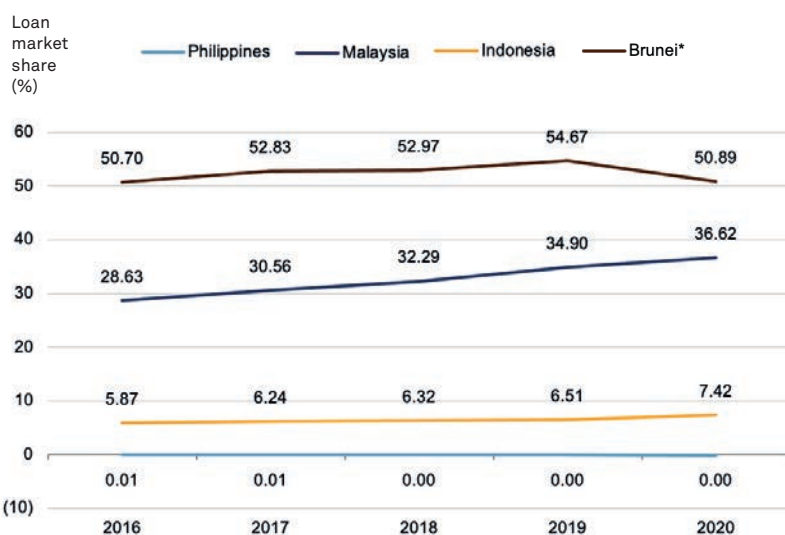
Development of Islamic finance is a part of the financial inclusion agenda of the Philippine central bank. About 5%-6% of the population is Islamic, residing in highly underbanked regions. So, there is a potential market to capture. State-owned Al Amanah Islamic bank, a subsidiary of Development Bank of the Philippines, is the only Islamic commercial bank in the Philippines. Al Amanah is likely to lead development initiatives including opening of branches or Islamic finance windows. We don't expect material progress from other banks given they have not shown much interest in serving this market. This could be due to high cost of setting up branches in the region as well as potentially higher credit risk due to the low-income profile of the borrowers.

**Chart 3 - Indonesian Islamic Banks Profitability Lags Conventional Banks**



Source: S&P Global Ratings.  
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**Chart 4 - Brunei And Malaysian Islamic Banks Have Large Market Shares**



\*For Brunei, market share is of Islamic bank assets as a % of total financial system assets.  
Source: S&P Global Ratings.  
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**How has COVID-19 impacted Islamic banks?**

Asset quality is both weaker and harder to measure, given distortions caused by forbearance and other supports. This is same as the headwinds facing conventional banks.

**Malaysia: Loan moratoriums mask asset quality stress.**

Malaysia will begin a new six-month blanket loan moratorium from July 7, prolonging the path to recovery for all the country's banks including the Islamic lenders.

As Islamic banks similarly benefited from the six-month blanket moratorium between April to September last year, nonperforming financings (NPFs) have been flat. The NPF ratio for Islamic banks was 1.3% at end-2020, compared with 1.4% in 2019. We think the asset quality trend of Malaysian Islamic banks will follow similar trends and patterns as their conventional peers given their largely identical credit profiles. That means close to 50-60 bps credit cost for the industry by the end of 2021.

In addition to asset quality challenges, the pandemic has led to accelerated adoption of digital tools and solutions among Islamic banks, thus further closing gaps with their conventional competitors in the market.

**Indonesia: Large-scale restructuring may mask asset quality issues.**

NPF ratios could rise over the next two years and credit costs will stay elevated. This is because the regulatory forbearance allowing restructured loans to be classified as performing is set to expire in March 2022. The reported NPF ratio for the Islamic banking sector was flattish at 3.1% by end-2020 compared to 3.2% in 2019 but restructured loans increased significantly. Part of these restructured loans could potentially turn into NPFs in the absence of adequate business revival or improvement in incomes.

Overall credit growth is likely to be lower than pre-COVID levels but better than conventional banks. In 2020, Islamic banks expanded financing by 8.8% in 2020 compared with the 2.4% contraction of loans for their conventional counterparts.

In addition to asset quality challenges, COVID-19 has led to accelerated adoption of digital tools and solutions among Islamic banks. Mobile and internet banking transactions, digital payments have increased multi-fold in Indonesia. Banks are now focusing a lot more on enhancing digital capabilities. So, we believe IT and digital investments will be a key focus area over the next couple of years.

**Brunei: Low forbearance highlights limited impact of pandemic.**

The banking industry, including that of Islamic banks, will likely see tepid net intermediation margins 2021 as global interest rates remain lower for longer to aid the global economic recovery. Rates should inch up next year. We expect banks' credit costs to remain range-bound for the next 12-18 months. Domestic growth prospects have improved while the share of loans under regulatory forbearance remains low compared with that of peers in the region.

Banks provided COVID-related relief on a low single-digit share of loans at the end of 2020. Sectors that came under stress included aviation, tourism, and hospitality. We understand that loans under regulatory forbearance have declined substantially in the past few months and the bulk of borrowers have started repayments. Capital bases and liquidity in the sector will remain strong.

**Philippines: Pandemic weighs on growth and earnings.**

We expect operating conditions for banks and borrowers in the Philippines to improve only gradually. In our base case, banks' recovery to pre-COVID-19 levels will likely stretch beyond 2022. Higher NPFs, elevated credit costs and lower margins will hurt banks. Al Amanah saw a sharp contraction in its loan portfolio and a multi-fold jump in provisions for credit losses during 2020. As a result, the bank's net losses for the year widened by 15% to Philippine peso 86 million.

**What could be the key downside risk factors for Islamic banks?**

Liquidity weaknesses or fast-spoiling asset quality would hold back financing growth. A worsening COVID situation would be the main catalyst, in our view, of these downside risks to our base case that Islamic banks will expand at a faster rate than conventional peers.

Southeast Asia's overall banking recovery will likely be drawn out, hinging on domestic economic growth and vaccine rollouts. In Asia-Pacific, vaccine rollouts have been more gradual than in the West, due to limited supplies and vaccine hesitancy among the populations. Fully vaccinating roughly 70% of populations will likely take at least until 2022 in most emerging markets. As a result, economic recoveries are highly vulnerable to setbacks if the pandemic worsens and leads to renewed lockdowns.

Banks' financial profiles will remain under pressure as the timelines for recovery are pushed forward. Even once pre-pandemic performance is regained, we expect a lag effect on credit profiles before banks improve as they work through asset quality difficulties.



**Malaysia: Slow economic recovery, asset quality and liquidity will weigh on banks.**

We see three downside risks for Malaysian Islamic banks:

- Tempered economic recovery. We recently lowered our GDP forecast for Malaysia by 2.1 percentage points, to 4.1% for 2021, due to constraints from the recent resurgence of COVID-19 cases and consequent lockdowns. A slower GDP growth will translate into slower credit demand in the market.
- Delayed asset quality recognition. Malaysian Islamic banks generally have a larger share of exposure to borrowers that are more vulnerable to crises. This includes the household segment (such as the bottom 40% households in terms of annual income) and micro, small and mid-sized firms compared with their conventional peers. The extension and multiple rounds of relief measures rolled out by the government will delay addressing asset quality issues in these portfolios. The resulting uncertainty could dampen Islamic banks' lending appetite to those borrowers.
- Finally, the liquidity positions of Islamic banks are generally tighter than their conventional peers on a lower current and savings account (CASA) ratio in general. And some stand-alone Islamic banks could experience tightened liquidity conditions compared with conventional banks and Islamic banks as part of large banking groups in a flight to quality situation. This could again constrain the financing recovery this year.

**Indonesia: Slow economic recovery amid new aggressive variants is a key threat.**

Unlike with Malaysia, we nudged our GDP forecast for Indonesia down only a touch, to 4.4% in 2021. A slower economic recovery would be the key downside risk for Indonesian Islamic banks. This could weigh on the banks' credit growth, asset quality and profitability. Indonesian Islamic banks have seen a sharp rise in restructured loans. In a downside scenario, we could see higher NPFs from the restructured pool resulting in elevated credit costs and muted earnings.

**Brunei: Low downside risk.**

We expect the economy to benefit from improving energy prices and a stabilized public health situation. Brunei's oil and gas industry accounts for close to half of the country's GDP and more than 70% of government revenues. The government's strong net fiscal asset position and oil wealth accumulated over several years buffer against shocks. Brunei has been able to withstand last year's decline in energy prices and the COVID-19 pandemic, due to countercyclical spending by the government and contribution from the new downstream production of petroleum and chemical products. So, we believe that the downside risks are low.

**Philippines: Economic recovery is vital.**

A prolonged COVID crisis in the Philippines is likely to impair the debt-servicing ability of consumers, small businesses, and leveraged companies. The extent of the impact on banks depends on the economic recovery and stabilization of credit conditions in the second half of 2021 and 2022. Operating conditions for banks should improve only gradually, on the back of 6% growth in the economy in 2021 (down from our previous estimate of 7.9%). If Al-Amanah opts to utilize the central bank's relaxation of accounting and provisioning norms, that will delay the proper recognition of stressed exposures.

**Will Indonesia's new Islamic giant bank expand into the region or is it too soon?**

In our view, the immediate focus will largely be on the domestic-market potential.

The Indonesian government has created Bank Syariah Indonesia (BSI) with a vision to be among the top-10 global Islamic banks. In the next two to three years, the bank will likely focus on capitalizing on the opportunities present in Indonesia. The country houses a sizable Muslim population, there is growing preference for halal or Sharia-compliant products and services, and penetration of Sharia banking is very low. So, there's a lot of ground to cover in Indonesia before it starts expanding in the region.

Nonetheless, the natural expansion in terms of serving Indonesian expats in the region can happen sooner. For this purpose, BSI can use the overseas offices of its state-owned parent banks. Otherwise, breaking into other markets will take some time, and also be challenging. Malaysian banks are larger, they are very strong, and a lot of them have been looking at overseas growth opportunities because their home market Malaysia is a saturated one. BSI's competition will be far more intense in the region than at home.

As far as domestic competition is concerned, developments are limited. The country's largest private sector bank, PT Bank Central Asia Tbk, last year completed the merger of its Sharia subsidiary with Bank Interim. However, BSI has a head start and controls about of 50% of the Sharia banking sector's assets. Other Islamic banks are quite small in comparison. So, we believe BSI will maintain its dominant market position in Indonesia.

**Do you expect further consolidation in any other country?**

Yes, in Malaysia. Consolidation among small, stand-alone Islamic banks has been more vigorous than such activities for their bigger peers. This is inevitable given the increasing trend of consolidation in terms of businesses and resources into the hands of bigger players. Leveraging on their business and funding synergies with their parents, the Islamic bank subsidiaries under the eight local banking groups account for more than 76% of domestic Islamic financing market share as of end-2020, up from 67% back in 2010.

Several stand-alone, foreign investor-backed Islamic banks are struggling to make profits and are saddled with high nonperforming loans. Some foreign investors of those banks are already looking to exit Malaysia after years of underperformance. Transactions in the past few years include Malaysia Building Society Bhd's acquisition of Asian Finance Bank in 2017, and the failed merger attempt between Al Rajhi Bank and Malaysian Industrial Development Finance Bhd. in 2020. In our view, more such deals are likely if small Islamic banks cannot find a way to turn around their operations in the tough competition with local banking giants.

*This report does not constitute a rating action.*

# Islamic Finance In Turkey: Capital Availability Is Likely To Constrain Growth In Coming Years

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Islamic banks in Turkey, officially known as participation banks, have grown at a healthy clip in the past five years, and have ambitious plans for even faster growth. The sector increased its share of the overall banking market to about 7.2% of assets at year-end 2020 from 5.1% at year-end 2015. Meanwhile, sukuk issuance increased to \$14 billion from \$2 billion in the period. Such growth was achieved thanks to strong support from Turkish authorities, which have on several occasions asserted their view of the importance of Islamic finance as an additional tool to finance the Turkish economy.

## Key Takeaways

- The Participation Banks Association of Turkey, in its newly updated strategy, expects a doubling of participation banks' market share to 15% by 2025.
- We see this objective as challenging given the difficult economic and credit conditions and the capital support that such growth implies.
- If GCC-based shareholders of Turkey's private-sector participation banks do not inject additional capital, public-sector participation banks are likely to dominate growth.
- The pandemic, the energy transition, and Turkey's ambitions for electric cars could inspire greater use of social and green financing instruments, including Islamic finance products and particularly sukuk.

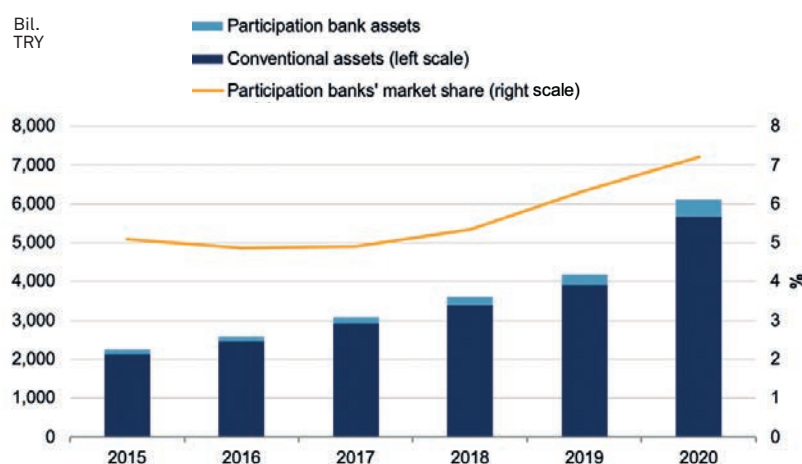
Earlier this year, the Participation Banks Association of Turkey (TKBB) announced a revised strategy to expand the sector further, reiterating the objective of reaching a market share of 15% by 2025. S&P Global Ratings believes that such an objective could be challenging to achieve and would necessitate significant additional support, notably capital. Gulf shareholders of some participation banks might be somewhat reluctant to inject additional capital over the next two years given the difficult Turkish operating environment, the volatility of the Turkish lira, and the challenges some of them face at home. Therefore, we think that state-owned participation banks will drive most growth.

The updated strategy includes objectives to standardize existing products and spur innovation. Indeed, we believe that products aligned with environmental, social, and governance (ESG) factors as well as liquidity management products are likely to foster growth. The pandemic, the energy transition, and Turkey's ambition to produce electric cars could inspire the increased use of social and green Islamic finance products. About standardization, it remains to be seen to what extent Turkey would be involved in crafting or would be inclined to adopt global Islamic finance standards, while at the same time retaining the option of developing and enforcing its own domestic standards. Another strategic objective is development of digital banking products where Turkish banks tend to be relatively advanced. Although digital could create some future avenues of growth in the banking business, we think it will mostly come in the payments and money transfer businesses.

## Islamic Banks Continue To Grab Market Share

The growth of Islamic banking in Turkey has markedly outstripped that of conventional banking over the past decade. At year-end 2020, market share for the country's participation banks reached 7.2%, compared with 5.1% at year-end 2015 and 2.5% in 2005 (see chart 1).

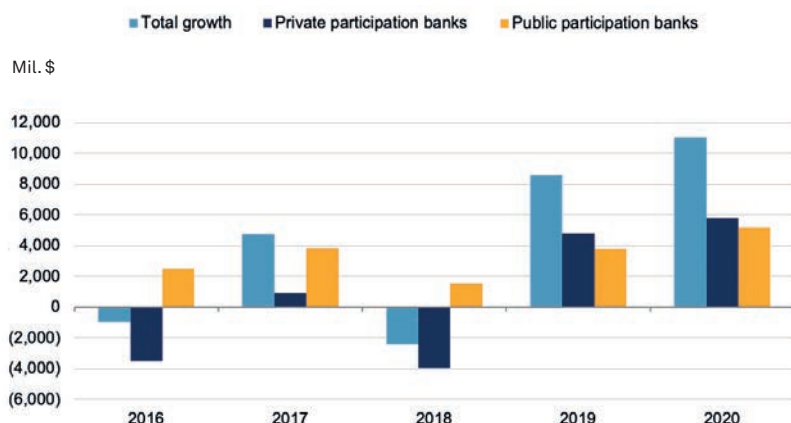
**Chart 1 - Turkey's Participation Banks Have Continued To Expand**



TRY--Turkish lira. Sources: S&P Global Ratings, Participation Banks Association of Turkey. Copyright © 2021 by Standard & Poor's Financial Services LLC. All rights reserved.



**Chart 2 - Public Participation Banks Are Slowly Taking Over As The Main Driver Of Industry Growth**

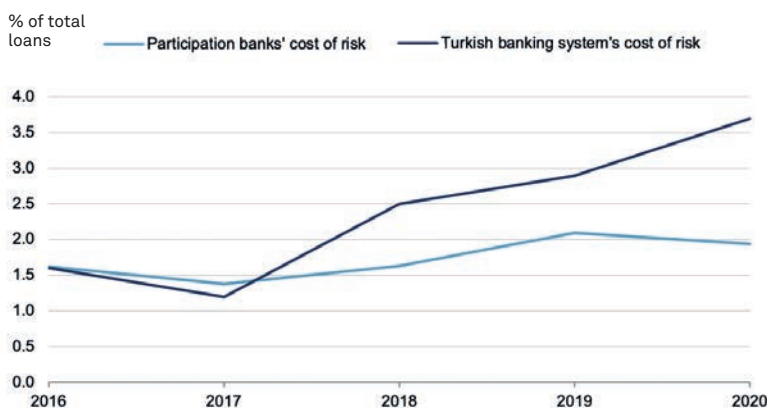


Sources: S&P Global Ratings, S&P Global Market Intelligence.  
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Since the inception of Islamic banking in Turkey in 1985, Islamic banks have largely grown thanks to privately owned capital, particularly through entities that are related to countries in the Gulf Cooperation Countries (GCC) such as Islamic banks in Kuwait and Bahrain. Government or public-sector banks had no Islamic lending operations until 2015 when the authorities decided to expand in this sector. At year-end 2020, public-sector participation banks accounted for 30% of total assets of participation banks and, more importantly, contributed to 47% of the growth in total assets of the sector (see chart 2).

Operating conditions for Turkish banks are likely to remain weak. We expect real GDP growth in Turkey to reach 6.1%, up from 1.8% in 2020, mostly due to a statistical carryover effect. Domestic demand is slowing due to adverse pandemic developments and tighter financial conditions, but exports are benefiting from the global economic recovery and depreciation of the Turkish lira. The vaccine rollout is accelerating, which could pave the way for an increase in tourism. However, we continue to expect only a very gradual recovery in international travel and see significant risks related to the development of the pandemic and the pace of the vaccination rollout.

**Chart 3 - Turkish Banks' Cost Of Risk**



Sources: S&P Global Ratings, S&P Global Market Intelligence.  
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We expect lending growth in the Turkish banking system to slow in 2021, averaging 15%, compared with 35% in 2020, due to government stimulus. State-owned banks are likely to generate most of the growth. In 2020, corporate lending increased due to heavy stimulus to households and small and midsize enterprises (SMEs) and the depreciation of the lira, which inflated borrowing in foreign currencies. Pockets of risks remain, though. The main one is our expectation that asset quality indicators will continue to worsen as regulatory forbearance measures are gradually lifted. We expect growth at participation banks to show similar trends as for the system.

We expect nonperforming loans for the banking system to exceed 10% of total loans by 2022 and cost of risk to rise to 320 basis points (bps) on average in 2021 and 2022, from an already high 290 bps on average in 2019 and 2020. For participation banks, the cost of risk has been slightly lower, averaging 200 bps in 2019 and 2020 due to strong entrenchment in the SMEs sector that benefited from government guarantees (covering 18% of total SME lending on April 30, 2021), their high exposure to the real estate sector, and, more generally, the asset-backing principle of Islamic finance that reduces the provisioning needs for some asset classes (see chart 3).

## New Strategy Aims To Further Push The Sector Forward

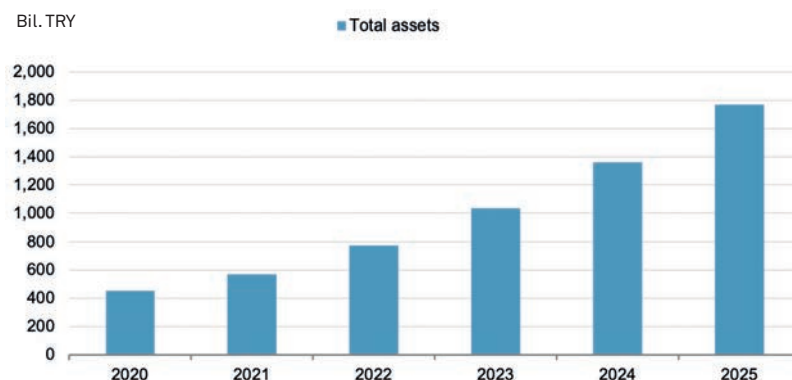
The TKBB's updated strategy for 2021-2025 maintains the objective of achieving a 15% market share by 2025, and as the reports states this would require a 31% compound annual growth rate. Moreover, TKBB's projections assume that shareholder equity in the sector will increase from Turkish lira (TRY) 34 billion to TRY156.8 billion (see chart 4). We view this objective as challenging.

There are six participation banks in Turkey, three of which GCC financial institutions partly own and three that the government owns. The shareholders for the three banks controlled by GCC financial institutions are Al Baraka Banking Group, Kuwait Finance House, and Saudi National Bank. In our view, we think GCC shareholders might be reluctant to inject as much capital as the TKBB expects given the higher risks in Turkey than in their home countries and the somewhat limited return on assets (ROA) of the sector compared with those at home. The average ROA for the sector stood at 1.1% over the past five years, lower than the 1.4% for the top 45 GCC banks over the same period. Moreover, for some shareholders, injecting more capital into their Turkish participation bank subsidiaries would come down to their limited capacity to free-up resources. Given these constraints, we believe public-sector participation banks in Turkey will drive future growth of the sector. At year-end 2020, the average Tier 1 ratio for the three private-sector participation banks stood at 12.3%, compared with 19.8% for public-sector participation banks.

The main growth pillars the strategy identifies are aligned with our view of the main potential accelerators for the global Islamic finance industry. They are:

- Finding business opportunities related to ESG,
- Further standardizing Islamic financial instruments while leaving room for innovation, and
- Using fintech and digitalization to create new business.

**Chart 4 - Growth Of Turkish Participation Banks To 2025**  
Projections by the Participation Banks Association of Turkey

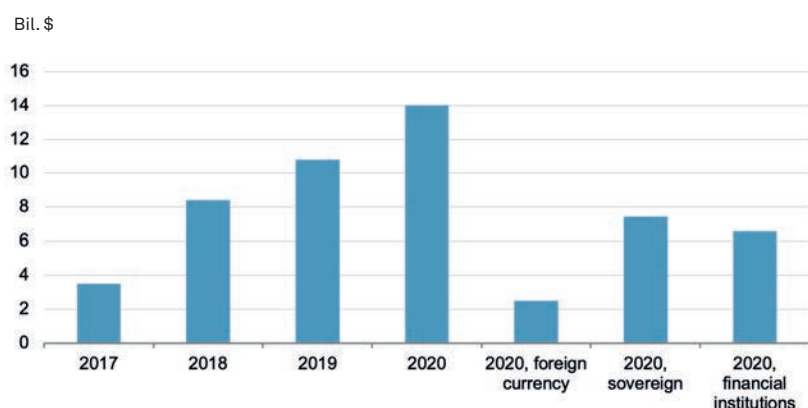


TRY--Turkish lira. Sources: S&P Global Ratings, Participation Banks Association of Turkey. Copyright © 2021 by Standard & Poor's Financial Services LLC. All rights reserved.

The alignment between Islamic finance principles and ESG is no longer to be demonstrated. There are two main avenues for Turkey. On the one hand, the country is likely to use Islamic social instruments to help deal with the aftermath of the pandemic. On the other hand, the country could potentially tap the green sukuk market to lay the foundation for more sustainable growth. The country's objectives in terms of increasing the contribution of renewable energy contribution in its energy mix, as well as its plans for electric cars could benefit from that. Although more complex than typical sukuk, green sukuk could broaden the investor base by attracting both ESG and Islamic investors. It is worth mentioning that we have not observed any pricing advantage for issuing green sukuk versus typical sukuk or conventional bonds. In addition, the sukuk market in Turkey remains dominated by financial institutions and sovereign issuance (see chart 5). We are of the view that opening this market to private-sector corporate issuers and stepping up sukuk offerings as liquidity management instruments could unlock some growth in the Islamic finance industry in Turkey.

We believe that standardization of legal documentation and interpretation of Sharia (harmonized with other core markets' interpretation) could help attract more investors. It remains to be seen to what extent Turkey would be involved in crafting or inclined to adopt global Islamic finance standards, and whether it would want to keep the option of developing and enforcing its own domestic standards to drive local innovation.

**Chart 5 – Sukuk Issuance In Turkey Is Increasing**



Sources: S&P Global Ratings, Eikon.

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Another area of growth lies in the digitalization and opportunities offered by fintech. Here, we are of the view that payment solutions and money transfers are the main growth areas in the next few years. Finally, it is important to mention that the strategy roadmap identifies clear deliverables and responsibilities, which is likely to help with its implementation and future success.

## Related Research

- Islamic Finance 2021-2022: Toward Sustainable Growth Through Greater Standardization And Integration, May 3, 2021
- Global Sukuk Issuance Is Set To Increase In 2021, Jan. 12, 2021
- GCC Banking Sector: A Long Climb To Recovery, March 14, 2021

*This report does not constitute a rating action.*

# Islamic Finance Is Still Finding Its Feet In North Africa

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The severe economic fallout from the COVID-19 pandemic and limited fiscal space for economies in the North African region are pushing governments to tap into all sources of financing, including those compliant with Sharia law. However, the lack of a favorable regulatory environment in the region is a major hurdle that has so far detracted from the success of Islamic finance there. While S&P Global Ratings believes that sukuk issuance could help mobilize external resources, it is neither a panacea nor free money. And while investors are actively chasing yield given the lower-for-longer interest rate environment, issuers with weaker credit quality are likely to find it more difficult to access the market. In this context, some North African countries might face some restrictions in tapping the market, even if they decide to follow the Islamic route.

## Key Takeaways

- Despite some progress over the past decade, the contribution of Islamic finance to North African economies remains small.
- We believe that some North African countries will slowly turn to the sukuk market to help finance the post-COVID-19 economic recovery.
- The industry is still trying to leverage its religious differentiation, though a stronger focus on its economic added value would be beneficial to shore up Islamic finance growth in the region.



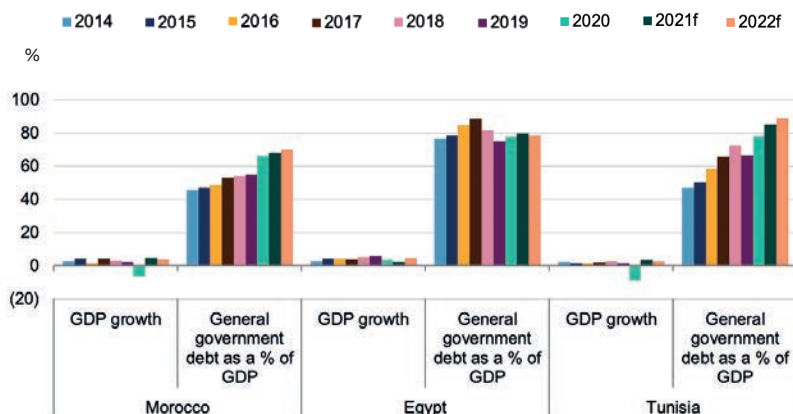
Islamic finance is not only about sukuk issuance, it also includes banking and insurance activities. While it has become slightly more prevalent over the past five years, the contribution of Islamic banks to the overall banking system in North Africa remains limited. This is largely because Islamic banks have focused less on their economic added value and more on leveraging their religious differentiation, sometimes offering products that are more expensive than conventional peers. In some countries, the limited refinancing sources for Islamic banks has also stymied their growth.

One lesson learned from its minimal development since the 1970s is that the presence of a Muslim population is a necessary, but insufficient, condition for the industry to thrive. A favorable regulatory environment and a stronger focus on the economic added value of this type of financing are also key factors. It remains to be seen whether the promulgation of a Unified Code for Islamic finance by The Dubai Islamic Economy Development Center and its partners would help make this a more popular financing route in the region.

## Turning To The Sukuk Market To Finance The Recovery

The sukuk market has seen significant global growth over the past decade, reaching \$538 billion at the end of 2019, with issuers in Gulf and Southeast Asian countries remaining the most active. Several North African governments were willing to tap the Islamic bond market in the aftermath of the Arab spring, as access to conventional financing sources was declining amid political instability and increased current account deficits. Both Tunisia and Egypt approved laws allowing sukuk issuances back in 2013; however, neither has issued any Islamic bonds since. Morocco is the only country in the region that has been able to issue a sovereign sukuk in 2018 (Moroccan dirham (MAD) 1 billion--equivalent to \$0.1 billion), one year after launching Islamic finance there.

**Chart 1 - COVID-19 Crisis Has Severely Affected Economies In North Africa And Further Heightened Their Indebtedness**



f--Forecast. Source: S&P Global Ratings.

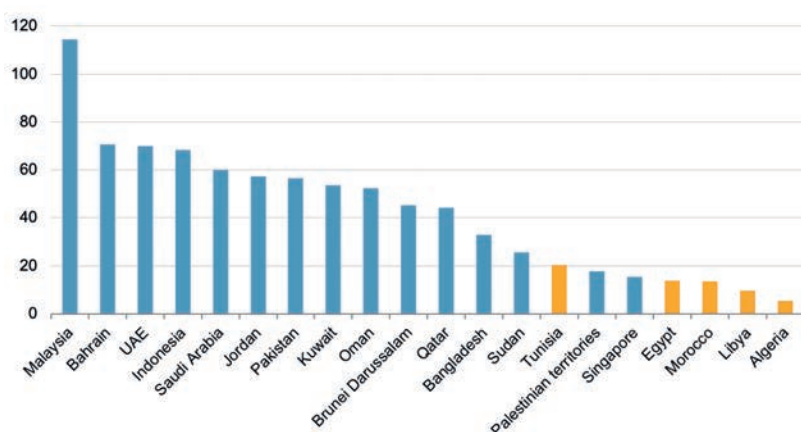
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Given the low interest rates globally and favorable liquidity conditions, some North African countries are looking to access the sukuk market this year to finance the post-COVID-19 economic recovery (see chart 1). Tunisia--whose fiscal deficit has reached an all-time high--is looking to tap the international sukuk market for around \$1 billion. Similarly, Egypt is preparing to tap both the international and local capital markets for its first sovereign sukuk issuance, which is still pending approval from the house of representatives.

Sovereign issuance of sukuk could help governments to finance their sizable funding needs while accessing a new, untapped class of investors. In addition, given the asset-backed principle in Islamic finance, we believe that sukuk could be the right fit for infrastructure and project finance in the region. This is because local banks typically lack the long-term funding capacity that these projects require. It remains to be seen, however, whether they will be able to attract enough investors this time. In our view, the persistent political backlog in Tunisia, with the absence of a consensus between the three branches of power--the president, prime minister, and parliament--along with weak economic prospects and elevated twin deficits, could constrain investors' appetite. In the case of Egypt, which has somewhat stronger prospects for economic growth, a sovereign sukuk issuance could attract some investors, but yields might be elevated.

**Chart 2 - ICD-Thomson Reuters Islamic Finance Development Indicator For Selected Countries As of 2019**

Islamic Finance  
Development  
Indicator (IFDI)



Source: S&P Global Ratings.  
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**Table 1 - Islamic Finance Statistics In North Africa  
Data as of December 2019**

	Total Islamic banking assets (bil. \$)	Islamic banks	Takaful companies	Islamic funds
Algeria	N.A.	3	1	0
Egypt	20	14	5	12
Libya	N.A.	0	1	0
Morocco	1	8	0	2
Tunisia	2	3	3	4
Total North Africa	28	28	10	18
Global	1993	526	336	1749
% of which is North Africa	1.42	5.32	2.98	1.03

N.A.--Not available.

N.A.--Not available. Source: S&P Global Ratings.

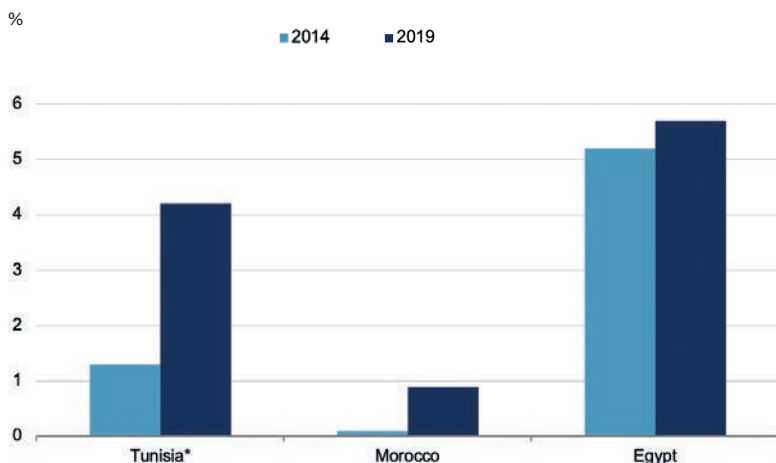
## An Industry That Remains In Its Infancy

Islamic finance first appeared in North Africa in the 1970s, with Egypt launching its first Islamic bank. Despite an early introduction in the region, the industry remained underdeveloped compared to other countries as shown through the Islamic Finance Development Indicator (IFDI)--a composite weighted index created by the Islamic Corporation for the Development of the Private Sector (ICD) and Thomson Reuters. IFDI provides an aggregate assessment of the evolution of Islamic finance based on five pillars: quantitative developments, knowledge, corporate and social responsibility, governance, and awareness (see chart 2).

Over the past decade, the number of active players in Islamic finance (including banking, insurance, and funds) in the region has slightly increased, mainly due to Morocco launching its first Islamic financial institution in 2017. Nevertheless, they still only represent between 1%-5% of institutions in their respective industries (see table 1).

Overall, the penetration of interest-free banking activity in North Africa remains limited. With 28 banks out of 526 globally, the contribution of the sector to global banking assets is below 2%. Despite the increasing appeal of Islamic banking for regulators, banks, and governments--especially in the aftermath of the Arab Spring--it remains a niche market in Egypt and Tunisia, with a market share of total banking assets below 6% (see chart 3). As a late entrant to the industry, the Moroccan government has so far adopted several regulations to enhance the development of the industry and was one of the fastest growing markets in Islamic finance in 2019. However, the industry remains in its infancy in the region. The recent launch of Islamic products by a state-owned bank in Algeria in August 2020 may also pave the way for other banks to offer interest-free banking.

**Chart 3 - Contribution Of Islamic Banking Activity To Total Domestic Assets**



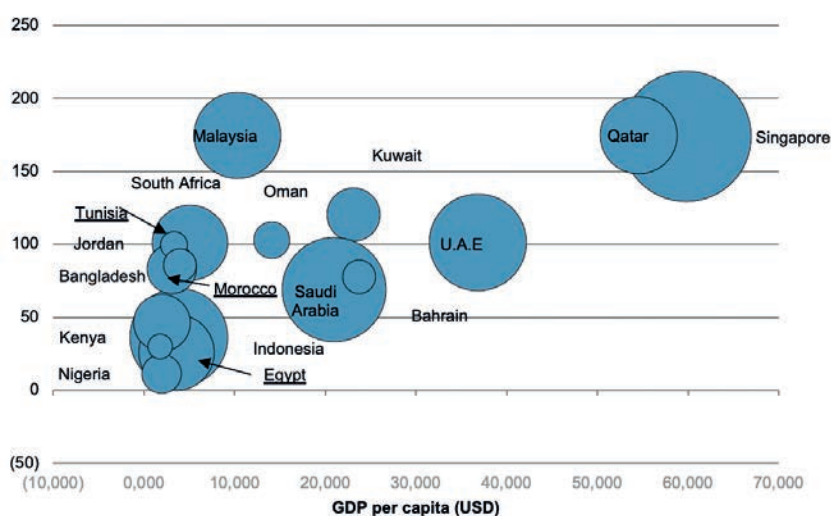
\*The increase in Tunisia is mainly due to the conversion of EL Wifack Leasing to a fully fledged Islamic bank. Source: S&P Global Ratings.  
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## Measuring Up Against Conventional Finance

Given the low rate of banking penetration in the North African region (see chart 4), we think that Islamic banking could make its mark as an alternative to conventional banking, while at the same time being complementary to it. We believe this might be possible if Islamic finance provides access to a new, untapped class of investor and customer. Beyond proposing Sharia-compliant products to the already-banked population, greater access to lending to low-income households and small and midsize enterprise (SME) and very small enterprise (VSE) segments--which together make up between 60%-90% of the region's economic fabric--could contribute to the development of the industry. While increasing financial inclusion, this could also boost economic development, which has been significantly affected by the COVID-19 crisis.

**Chart 4 - Banking Penetration In North African Countries Is Lower Than Peers**

Private sector claims as a % of GDP



Bubble size represents total domestic assets of financial institutions in 2020 in USD.  
Source: S&P Global Ratings.  
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The ability of active players to offer a wide range of products under convenient financial conditions will also determine the future of Islamic finance in the region. As GDP per capita is much lower than in other regions where growth in Islamic finance has accelerated, we think that pricing could be a key variable in determining customer preferences. Fierce price competition in some of the North African markets indicates that customers in these regions are more sensitive to the costs associated with banking products.

In order to broaden its reach, the Islamic finance sector still needs to increase awareness of its concepts among customers and investors, as well as completing its framework. In particular, we believe that market players, regulators, and relevant institutions in the region would benefit from tighter coordination to:

- Improve market understanding about the principles and practices of the industry;
- Widen the product offering to meet all customers' needs (some jurisdictions only propose Murabaha, for example, thus excluding the needs of corporates and SMEs); and
- Develop new products in other financial segments--namely capital markets and insurance--which remain embryonic or inexistant, depending on the jurisdiction. For example, in Morocco, upon approval of the pending legislation, we think that several players would be interested in developing Takaful activity (the equivalent of insurance in Islamic finance) to tap the unexploited potential of this market. In our view, this could also help reduce the risk that participating banks currently undertake as they provide Murabaha without any insurance.

## Related Research

- Islamic Finance In Turkey: Capital Availability Is Likely To Constrain Growth In Coming Years, May 3, 2021
- Islamic Finance 2021-2022: Toward Sustainable Growth Through Greater Standardization And Integration, May 3, 2021
- Global Sukuk Issuance Is Set To Increase In 2021, Jan. 12, 2021
- GCC Banking Sector: A Long Climb To Recovery, March 14, 2021

*This report does not constitute a rating action.*

# Islamic Finance: Syndication Could Make Up For Sukuk's Shortcomings

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Core Islamic countries such as Turkey, Malaysia, Indonesia, and those in the Gulf Cooperation Council (GCC) are facing a major economic contraction in 2020 because of COVID-19 and low oil prices. Governments' financing needs have increased sharply as a result of the pandemic, while corporates are cutting capital expenditure and holding on to cash.

### Key Takeaways

- This year's sudden contraction of global economies has seen core Islamic countries meet rising expenditure through syndicated financing rather than sukuk issuance.
- Corporate entities have been using bank facilities mainly to stay afloat, since the majority have cut capital expenditure to adjust to the new economic reality.
- Although Islamic syndication may appear to be more accessible than sukuk issuance, it remains more complex than conventional syndicated deals.

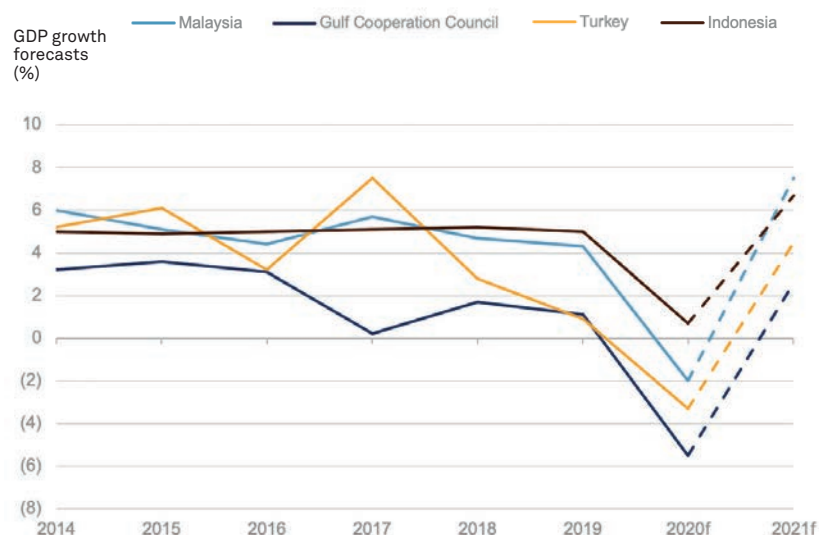


S&P Global Ratings has observed that the Islamic syndicated loans market has been modestly outperforming the sukuk market this year. Although the bulk of syndicated deals--totaling more than \$50 billion--remain conventional, we believe Islamic syndications could increasingly complement traditional financing options. Because such syndications involve a limited number of counterparties, they could support quicker and easier issuance than is the case for sukuk.

## The Downturn Has Pushed Islamic Issuers Toward Conventional Capital Markets

Islamic countries tend to seek conventional financing in times of crisis. This year, GCC governments and government-related entities have tapped the conventional markets for bonds and syndications more often than the sukuk market. There are several reasons for this, but the most common relates to the complexity of issuing Islamic instruments, particularly sukuk, due to a lack of standardization. Faster execution and larger amounts are the main factors behind GCC sovereigns' decision to take the conventional funding route in 2020. Governments' heightened need for financing stems largely from the oil price slump and the economic fallout of the COVID-19 pandemic (see chart). The last time we saw a similar surge in conventional issuance was in 2015.

**Chart 1 - Core Islamic Finance Economies Could Start Recovering Next Year**



f--Forecast. Source: S&P Global Ratings

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Compared with classic bank loans, by nature, syndicated deals, could attract larger amounts for longer tenors, since a consortium of banks would share the financing risks. Although syndicated transactions rely on underlying assets and mechanisms to ensure their capacity to generate revenue for the syndicates in a sharia compliant manner, they reportedly require less time and documentation than sukuk. Syndicated deals executed in the first half of 2020 totaled \$50.1 billion in the core Islamic finance countries, which represented about 40% of total transactions in 2019. By contrast, total sukuk issuance dropped 27% in the first half of this year. We've observed some improvement recently however, suggesting that the steep drop in sukuk issuance volumes might not be indicative of the market's full-year performance.

## Bank Lending Will Become More Selective As Credit Risk Rises

Central banks in some core countries have increased the flow of liquidity, asking banks to channel these funds to local corporations to support economic activity. Yet we expect banks' risk appetite will lessen in light of the economic stress in the region. Corporates have so far sought bank financing mainly to meet near-term liquidity needs, and most have been accessing bank financing to take advantage of subsidized rates rather than to support expansion.

We forecast bank lending will increase by low- to mid-single digits in most core Islamic finance countries in 2020. The lower pricing of bank facilities versus market financing could act as an incentive for corporates. Nevertheless, corporates have cut capital expenditure and introduced cost-reduction measures, particularly in more exposed sectors such as real estate, aviation, and tourism. Some have also reduced dividends and rolled over short-term bank borrowing to preserve their cash balances.

### Islamic Syndication Gives Borrowers Tangible Benefits

Islamic syndication could make up for sukuk shortfalls in terms of complexity and time. Syndicated finance enables corporate entities and governments to raise large amounts for a longer duration, while avoiding the intricacies of capital market issuance. This is because of the smaller number of parties and faster execution. Also, for conventional syndications, legal documents are standardized and tested. For Islamic syndication, the issuance process tends to be more complex, but the involvement of few parties make them relatively easier to execute compared with sukuk. In addition, these transactions are not market transactions and therefore do not require market authorities' approval.

Another key benefit is that Islamic syndications would attract Islamic banks, whose assets totaled \$1.8 trillion at year-end 2019, as well as conventional ones. A larger investor base could help the market flourish, since Islamic governments and corporates usually prefer Islamic instruments.

### Economic And Market Uncertainties May Favor Syndication

At the end of the day, executing Islamic syndication could prove more cumbersome than the issuance of conventional instruments. The necessity of having one or several underlying assets, agreeing on Sharia standards, and structuring transactions in an income-generating manner are just a few examples. In addition, recent market volatility has made it more difficult for corporates to access the market amid rapid changes in creditworthiness.

While market conditions are slowly improving, we think issuers with good credit quality are likely to remain on investors' radar. The choice of instrument will depend on considerations related to cost, timeliness, complexity, and Sharia preferences. In this context, we believe that syndication could become a more permanent vehicle for Islamic finance, complementing the sukuk market.

#### Related Research

- Global Sukuk Market: A Window Of Opportunity Is Opening, July 7, 2020

*This report does not constitute a rating action.*

# Stress Scenarios: How GCC Banks Will Perform Amid Further Potential COVID-19 Shocks

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**S** &P Global Ratings believes that the COVID-19 pandemic will continue to dominate the credit story for Gulf Cooperation Council (GCC) banks this year, as part of the wider narrative for emerging markets (EMs). In our view, vaccine rollouts and exceptionally accommodative monetary policy from developed market central banks will support recovery and financing conditions for EMs, excluding a major shift in investor sentiment. However, we still expect the asset-quality indicators of banks in EMs to weaken, with the GCC no exception.

**Key Takeaways**

- Rated GCC banks set aside \$10.9 billion of new loan-loss provisions in 2020 because of the expected hit from COVID-19 and low oil prices on their asset-quality indicators.
- We expect more provisions in 2021 as regulatory forbearance measures are lifted by regulators and banks recognize the full impact of the shock.
- We have conducted two simulations of the credit losses rated banks can absorb under different scenarios--one focusing on banks' profitability and excess provisions on existing nonperforming loans and one considering buffers exceeding our risk-adjusted capital thresholds from a ratings perspective.
- Based on our calculations, the total capacity for credit loss absorption before losses is \$31 billion-\$45 billion, depending on the assumptions.

For this report, we estimated rated GCC banks' credit loss absorption capacity under different scenarios of nonperforming loan (NPL) coverage by reserves using two simulations. In the first, we focused on banks' profitability (net operating income before provisions) and any excess or deficit of provisions compared with our predetermined coverage thresholds. In the second, we incorporated banks' excess capital buffers in our calculation of their risk-adjusted capital (RAC) ratio relative to the threshold for a weaker assessment of capital and earnings.

Overall, we estimate that rated banks in our sample can absorb a shock of \$31 billion-\$45 billion (in aggregate) with a limited automatic effect on our assessment of capitalization. This rises to \$114 billion when banks hit the boundaries for a potentially weaker assessment of capital and earnings under our criteria and corresponds to a 3.1%-11.3% increase in their NPLs.

The largest absolute capacity to absorb losses lies with Saudi banks, which dominate the pack due to their size. When compared with total lending, Kuwait's banks stand out given their significant provisions accumulated over the years. At year-end 2020, the total lending of banks in our sample was about \$1.0 trillion.

Of note, these aggregate numbers do not reveal important differences between banks. Equally, the figures do not necessarily speak to potential ratings movement because they cover only one narrow angle of banks' credit stories--although they do provide valuable insights for our analysis.

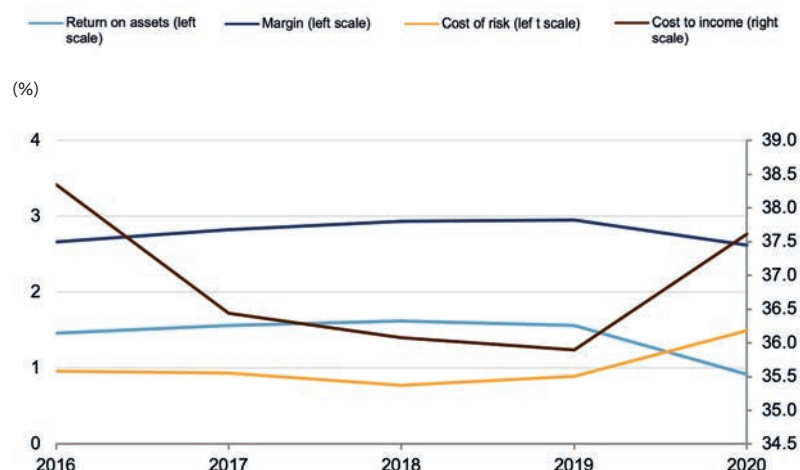
S&P Global Ratings believes there remains high, albeit moderating, uncertainty about the evolution of the coronavirus pandemic and its economic effects. Vaccine production is ramping up and rollouts are gathering pace around the world. Widespread immunization, which will help pave the way for a return to more normal levels of social and economic activity, looks to be achievable by most developed economies by the end of the third quarter. However, some emerging markets may only be able to achieve widespread immunization by year-end or later. We use these assumptions about vaccine timing in assessing the economic and credit implications associated with the pandemic (see our research here: [www.spglobal.com/ratings](http://www.spglobal.com/ratings)). As the situation evolves, we will update our assumptions and estimates accordingly.

## The Pandemic Has Already Cost Rated GCC Banks \$10.9 billion In New Provisions

Over the past 12 months, GCC banks have set aside \$10.9 billion of additional credit loss provisions for the expected negative impact of the COVID-19 pandemic and drop in oil prices on their economies. Despite regulatory forbearance measures, which allowed banks to smoothen the profitability hit, cost of risk for rated banks increased by almost two-thirds--reaching 150 basis points (bps) at year-end 2020 compared with 90 bps at year-end 2019. Some banks were exposed to specific one-off default cases (such as the significant fraud that occurred in a large corporate or the liquidation of a major construction company in the United Arab Emirates [UAE]). Others, simply decided to err on the side of caution and took provisions to prepare for the lifting of regulatory forbearance measures, which would almost certainly crystallize some risks. Although we expect forbearance measures to be lifted in 2021, the process should be smooth, with regulators unlikely to take major steps that could endanger the financial health of their banking systems, in our view. Furthermore, we note that, despite an increase in cost of risk, most rated banks remain profitable and only a few showed statutory losses in 2020, either due to high exposure to vulnerable asset classes or management's conservative stance in dealing with the shock aftermath. GCC banks' high contribution of net interest income to total revenue, hefty margins, and sound operating efficiency have also helped their performance (see chart 1).

## What Additional Credit Losses Can Rated Banks Absorb?

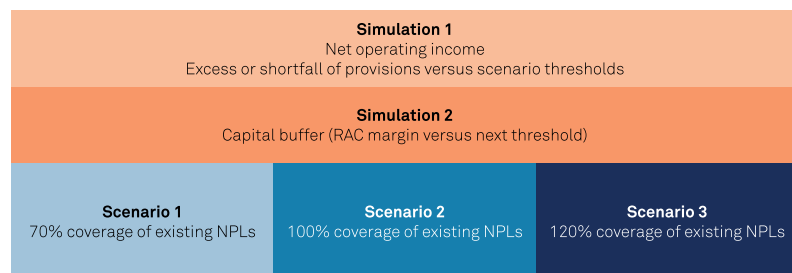
To assess banks' buffers against credit losses, we conducted two simulations using three scenarios. The first simulation starts with reported numbers for banks' net operating income before loan-loss provisions for 2020 because these already account for any negative COVID-19-related effects from lower interest margins and declining lending growth. We then looked at the existing stock of NPLs (or assets, depending on the system and using year-end 2020 numbers). We compared this stock to the existing loans-loss provisions using three assumptions:

**Chart 1 – Rated GCC Banks Remained Profitable Despite The Shock**

GCC--Gulf Cooperation Council. Source: S&P Global Ratings, S&P Global Market Intelligence. Copyright © 2021 by Standard & Poor's Financial Services LLC. All rights reserved.

- Scenario 1: 70% coverage of the existing NPL stock. This is commensurate with other EM countries' loss experience.
- Scenario 2: 100% coverage of the existing NPL stock. Here, we pushed the stress a bit further and assumed that recovery prospects would differ from historical performance due to the pandemic. In addition, given regulatory forbearance measures, we think that the full extent of COVID-19-related asset-quality deterioration is yet to crystallize.
- Scenario 3: 120% coverage of the existing NPL stock. This factored in any additional provisions banks might take on International Financial Reporting Standard 9 Stage 1 and Stage 2 loans.

Looking at the profit and loss statement gives only a partial view of banks' loss-absorption capacity. Therefore, in our second simulation we used banks' projected RAC ratios, stripping out the existing margin in each RAC ratio compared with the lower threshold in our methodology typically associated with maintaining the same capital and earnings assessment. This margin was then converted into loan-loss absorption capacity using the coverage ratio assumption. These numbers do not necessarily speak to potential rating movement because they cover only one narrow angle of banks' credit stories. For example, our assessment of risk position serves to refine the view of a bank's actual and specific risks beyond the conclusion arising from the standard assumptions in the capital and earnings analysis. Therefore, a RAC projection falling under a certain threshold would not automatically lead to a lower rating under our criteria. Conversely, we could lower our ratings on banks well ahead of credit losses that lead to our projection falling below any of these thresholds. Nevertheless, these figures do provide valuable insight in our analysis.

**Chart 2 – Simulation Methodology**

NPL--Nonperforming loan. RAC--Risk-adjusted capital. Source: S&P Global Ratings. Copyright © 2021 by Standard & Poor's Financial Services LLC. All rights reserved.



## Rated Banks' Capacity To Absorb Losses Varies Significantly

In aggregate, banks in our sample can withstand a shock of \$31 billion-\$45 billion based on simulation 1 and \$54 billion-\$114 billion based on simulation 2--depending on the scenario. Saudi Arabia represents 40%-50% of these numbers given Saudi banks are the largest contributor in our sample. They are followed by Qatari banks, but this is instead due to their strong profitability and capitalization, with Kuwaiti banks the third largest contributor. Bahrain and Oman's marginal contribution is explained by the limited number of rated banks in each country, while for the

UAE in fourth it is explained by the lower starting point for the coverage ratio. Looking at the relative numbers gives a better perspective on loss-absorption capacity. Kuwait is the outlier here based on the first simulation thanks to the significant provisions accumulated over the years. Saudi and Qatar have the second and third highest resilience due to banks' strong profitability in these countries. The UAE came fourth due to asset-quality issues that emerged in 2020, which have reduced banks' capacity to absorb losses (see table 1). When adding the capitalization angle, credit loss absorption capacity increases significantly. GCC banks tend to have strong capitalization, which will help them navigate the stressed operating environment (see table 2).

**Table 1 - Absolute Credit Loss Absorption Capacity**

(Bil \$)

	Simulation 1				Simulation 2		
	70% coverage	100% coverage	120% coverage		70% coverage	100% coverage	120% coverage
Bahrain	1.8	1.4	1.1	Bahrain	4.7	2.9	2.2
Qatar	11.3	9.5	8.3	Qatar	26.2	16.6	12.8
Kuwait	5.8	5.2	4.8	Kuwait	11.6	7.5	5.9
United Arab Emirates	7.2	3.6	1.1	United Arab Emirates	24.2	13.3	9
Saudi Arabia	18.2	16.2	14.9	Saudi Arabia	43.6	28.5	22.7
Oman	1.1	0.9	0.7	Oman	3.5	2.2	1.7
Sum	45.5	36.8	30.9	Sum	113.9	71	54.3

Note: For example, with 100% coverage, rated banks in Qatar can absorb a \$9.5 billion increase in nonperforming loans based on Simulation 1 results. Source: S&P Global Ratings

**Table 2 - Relative Credit Loss Absorption Capacity**

(%)

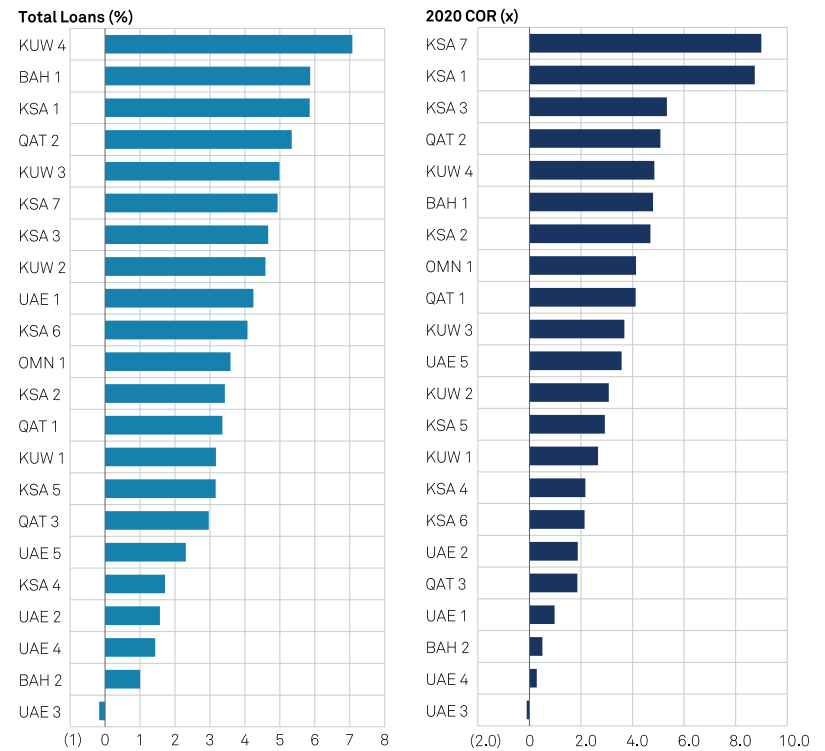
	Simulation 1				Simulation 2		
	70% coverage	100% coverage	120% coverage		70% coverage	100% coverage	120% coverage
Bahrain	4.9	3.7	3.0	Bahrain	12.6	7.7	5.8
Qatar	4.2	3.6	3.1	Qatar	9.8	6.2	4.8
Kuwait	5.5	4.9	4.6	Kuwait	10.9	7.1	5.6
United Arab Emirates	3.4	1.7	0.5	United Arab Emirates	11.2	6.2	4.2
Saudi Arabia	5.1	4.5	4.2	Saudi Arabia	12.2	8.0	6.3
Oman	4.7	3.6	2.9	Oman	14.6	9.1	7.0
Weighted average	4.5	3.7	3.1	Weighted average	11.3	7.0	5.4

Source: S&P Global Ratings.

Furthermore, to assess the magnitude of calculated loss-absorption capacity, we have compared the results of scenario 2 with individual banks' total loans and reported cost of risk for 2020. Based on simulation 1, the top five banks with the highest capacity to absorb losses were in Kuwait, Bahrain, Saudi Arabia, and Qatar. The bottom five were in the UAE, Bahrain, and Saudi Arabia. If we add the capitalization angle, the picture doesn't change materially.

**Chart 3 - Individual Loss Absorption Varies Significantly**

Simulation 1

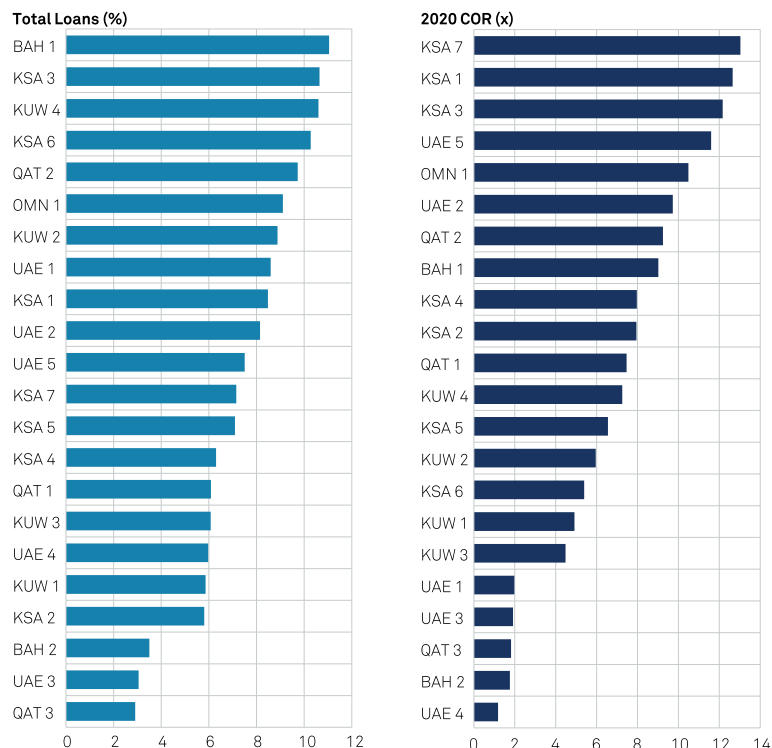


COR: Cost of risk. Source: S&P Global Ratings.

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**Chart 4 - Individual Loss Absorption Varies Significantly**

Simulation 2



COR: Cost of risk. Source: S&amp;P Global Ratings.

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Note: For example, for KUW4, the loss absorption capacity is equivalent to 7.1% of total loans and 4.8x the cost of risk of 2020.

## GCC Banks Face A Long Climb To Recovery

Despite the recent rally in oil prices and brighter near-term outlook for economic recovery, GCC banks' operating performance will remain constrained by the protracted recovery in key economic sectors and low interest rates. S&P Global Ratings expects GDP growth in the GCC countries will slowly recover from last year's sharp recession triggered by the COVID-19 pandemic and low oil prices. However, we see long-lasting adverse effects from the 2020 shock on GCC economies and banking sectors. Saudi and Qatar's banking sectors will be less affected than those in the UAE, Oman, and Bahrain, while in Kuwait the story will depend on the evolution of the fiscal impasse.

We expect banks' asset-quality indicators will continue to deteriorate and cost of risk to remain high as they start recognizing the true impact of 2020 and forbearance measures are lifted in second-half 2021. Given continued low interest rates, banks' profitability will remain low in 2021 and beyond, with some potentially showing losses this year. Nevertheless, strong, and stable capital buffers, good funding profiles, and expected government support should continue to reinforce banks' creditworthiness in 2021.

### Related Research

- GCC Banking Sector: A Long Climb To Recovery, March 14, 2020
- Good Earning Capacity Gives Rated Banks In Emerging Markets A Buffer From COVID-19's Effects, Feb. 22, 2021
- Banks In Emerging Markets: 15 Countries, Three Main Risks (January 2021 Update), Jan. 19, 2021
- Dubai's Property Market In 2021: A Tough Year On The Road To Recovery, March 1, 2021
- Saudi Banking Sector 2021 Outlook: Growth Hinges On Mortgage Lending And Public Spending, Feb. 23, 2021
- UAE Banking Sector 2021 Outlook--A Long Recovery Road Ahead, Jan. 26, 2021
- GCC Banks: Lower Profitability Is Here To Stay, Oct. 13, 2020

*This report does not constitute a rating action.*

# External Auditing Of Sharia Compliance Will Likely Strengthen Governance In Islamic Finance

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In early May 2021, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) published its auditing standard No. 6, which specifies its criteria for external audit of Sharia compliance at Islamic financial institutions (IFIs). In S&P Global Ratings' view, this is a step forward for the industry and will reinforce governance and enhance market discipline. In this context, key aspects of market discipline include greater consistency in adhering to Sharia principles and a culture of rapid remedial action by noncompliant institutions, in response to wider market and investor demands.

## Key Takeaways

- AAOIFI's latest auditing standard sets out criteria for external auditing of a financial institution's Sharia compliance and provides some guidance on the key considerations, when performing this exercise.
- At present, there are no unified Sharia rules that all Islamic financial institutions must follow. AAOIFI addresses this by creating a hierarchy of the existing standards and regulations.
- In our view, enforcing the new auditing standard should enhance Sharia governance and market discipline in Islamic financial institutions.

Given the lack of standardization that the Islamic finance industry has been facing, the first problem AAOIFI faced was, which standards should an audit exercise be performed against? In its No. 6 standard, AAOIFI addresses this by creating a hierarchy of the existing standards and regulations.

If opinions from these sources are ambiguous, the standard prioritizes the approvals and clarifications of the entity's specific Sharia board. This is the obvious choice, given that these approvals and clarifications underpin an IFI management team's decisions and the institution's functioning.

Internal Sharia audits are already performed on some IFIs, such as Islamic banks and takaful companies, but the findings are not published. Although they give stakeholders some assurance that they are compliant, they present an inherent conflict of interest. In our view, internal auditing has not meaningfully supported enhanced transparency. Enforcing external, independent audits, however, could change the game, especially if the detailed results were published, or at least shared with the IFI's key stakeholders. These would include holders of unrestricted investment accounts (URIAs).

AAOIFI does not specify if the standard will apply to market instruments issued by entities that are not subject to internal Sharia audit (for example, corporate or sovereign sukuk issuers). In our view, extending the practice of external audits to these instruments could also help strengthen their credibility.

### Creating An External Audit Rulebook

AAOIFI's aim, in publishing its auditing standard No. 6, was to preserve the stability of Islamic finance markets and provide some guidance on how to perform an external audit of an IFI's Sharia compliance.

The new standard creates a hierarchy of the regulations, standards, and rulings against which the auditing exercise is to be performed. In order, these are:

- The Sharia standards issued by the AAOIFI.
- The regulations issued by the institution's regulator if these include Sharia requirements.
- The rulings of the central Sharia board of the specific jurisdiction in which the institution is based.
- The requirements of the accounting standards of the AAOIFI, if these include Sharia requirements.
- The approvals and rulings of the Sharia board of the institution.

Moreover, the AAOIFI explains that if there is any ambiguity in interpreting the first four of these directions, the institution's Sharia board's clarification will prevail. In our view, this will make it easier to adopt standard No. 6. AAOIFI's standards have not been widely adopted, and only few core Islamic finance countries use the AAOIFI Sharia standards in full as part of their local regulation. In addition, not all Islamic finance core markets even have centralized Sharia boards.

### Markets Will Welcome Greater Transparency

In our view, external sharia audits could strengthen market discipline, especially if detailed audit reports are published or at least communicated to the IFI's key stakeholders, including the URIA holders. Stakeholders would prize access to more information related to Sharia compliance and the industry would benefit from greater consistency in adhering to Sharia principles. We also anticipate a stronger culture of rapid remedial action, where audits uncover noncompliance.

At present, some IFIs are subject to internal Sharia audit, but the results are typically not published. In addition, as the exercise remains internal, there is an inherent conflict of interest. Some entities may be given the opportunity to implement corrective measures, should the internal auditor discover that they were not compliant.

By contrast, with external audits, the auditors are likely to be independent from the institution. AAOIFI recommends that professional accounting and auditing firms perform the audit. In our view, publication of the audit report could strengthen market discipline and increase transparency. Stakeholders would have access to relevant information related to the Sharia compliance of their institution and could take remedial actions, if necessary.

The No. 6 standard doesn't specify whether it applies to individual transactions--for example, sukuk sponsored by entities that are not themselves subject to external Sharia audit. Internal Sharia boards typically perform Sharia validations before sponsoring transactions. However, we think an external Sharia audit could strengthen the industry's credibility and avoid situations where issuers question the compliance of instruments after transactions have closed.



## Sharia Compliance Indirectly Affects Our Ratings

S&P Global Ratings neither structures transactions, nor does it opine on Sharia compliance. That said, noncompliance could have significant reputational and financial effects for IFIs and, ultimately, could affect their creditworthiness.

Some issuers and debtors have also used Sharia compliance to try to avoid honoring their financial obligations, although their argument has generally been dismissed during the resulting legal proceedings. In some instances, payments were delayed, resulting in the default of the entity. Since then, we have started to see clauses in issuance legal documents that prevent issuers from questioning the Sharia compliance of their instruments after closing.

In our view, external Sharia audits could strengthen the corporate governance of eligible institutions. If management teams know to expect such audits, they will see little benefit in adopting practices that might be perceived as not being Sharia-compliant. In turn, this could enhance stakeholders' confidence in IFIs. By publishing external audits of its Sharia compliance, an IFI could also minimize the risk of being perceived as either noncompliant or nontransparent.

## Related Research

- Islamic Finance Is Still Finding Its Feet In North Africa, May 12, 2021
- Islamic Finance 2021-2022: Toward Sustainable Growth, May 3, 2021
- Islamic Finance In Turkey: Capital Availability Is Likely To Constrain Growth In Coming Years, May 3, 2021
- The U.K.'s Second Sukuk Issuance Is Positive For The Market But Not A Game Changer, March 31, 2021
- Global Sukuk Issuance Is Set To Increase In 2021, Jan. 12, 2021

*This report does not constitute a rating action.*

# Islamic Insurers May Not Sustain Strong Profitability Throughout 2021

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Unlike in the corporate sector, where the pandemic led to widespread downgrades in 2020, our credit ratings on Islamic (Takaful) and conventional insurers in the Gulf Cooperative Council (GCC) have remained broadly stable over the past 18 months, supported by relatively strong capital buffers. Indeed, we have taken several positive rating actions on Takaful companies so far this year. Our outlook on the sector for the next 12 months remains stable. However, given that risks related to the pandemic persist, we could take rating actions in the event of a sharp decline in asset prices, unexpected and severe technical losses, or governance and internal control failures.

## Key Takeaways

- We expect our ratings on Islamic (Takaful) insurers in the GCC to be broadly stable in 2021. However, persisting risks related to asset volatility, underwriting losses, and company-specific governance, and control failures could lead to some negative rating actions.
- Very intense competition and the weak performance of some key sectors such as travel, hospitality, and retail will likely weigh on growth prospects and earnings this year.
- Weak profitability among some smaller companies will necessitate further capital raising and consolidation in 2021, particularly in Saudi Arabia and Kuwait, where many companies in the sector continue to accumulate losses.

We expect an economic recovery in the GCC in 2021, supported mainly by the increase in oil prices--S&P Global Ratings recently revised its oil price assumption to \$65 per barrel for 2021 from \$60 previously--and the vaccine rollout. However, slow vaccination progress in some parts of the world and new variants could dampen the recovery. An uneven recovery, ongoing cost-saving measures in many industries, and a shift to less (business) travel has further increased the pressure in key sectors such as real estate, retail, transportation, and hospitality. We believe these factors, combined with very intense competition in the insurance sector, are weighing on growth prospects for gross written premiums/contributions of Takaful insurers, which recorded a modest increase of about 1.5% in 2020 and about 1.0% in first-quarter 2021 according to our calculations.

Very high competition in the overcrowded GCC insurance industry will continue to weigh on earnings in 2021. Despite a recent material improvement in profitability in Saudi Arabia's insurance sector, more than one-third of insurers continue to report losses. Pressure on solvency and certain regulatory incentives have led to a number of mergers in Saudi Arabia over the past year and we expect this trend to continue throughout 2021. A new insurance law with higher reserving requirements due to come into force over the next year, could also increase pressure on small and unprofitable Takaful players in Kuwait that will need to raise capital to meet these requirements. Overall, while we expect growth in the sector, we think it'll be unevenly spread, with larger conventional insurers taking more of the gains.

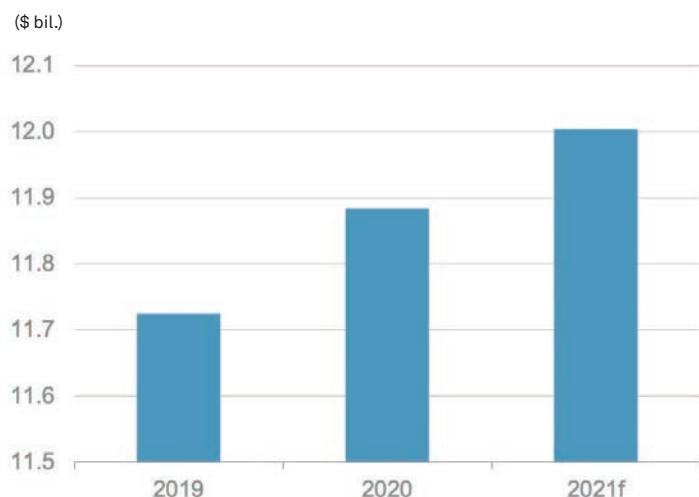
## Competition Has Further Intensified During The Pandemic

Gross written premium/contribution growth will likely remain weak in most GCC markets in 2021. Amid weaker economic conditions, gross written premium/contribution growth has been relatively modest in most GCC markets, partly from lower business activity and increased competition among Takaful and conventional insurers in recent years. This has particularly been the case in motor and medical lines, which together make up about 80% of total premium income in Saudi Arabia and more than 60% in most other markets in the region. Slowing population growth across the GCC, ongoing pressure on rates, and a drop in new car sales by about 16% in Saudi Arabia and 35% in the United Arab Emirates (UAE) and in other markets in the region in 2020 led to reduced insured values. Based on current market conditions and first-quarter 2021 results, we expect this downward trend to continue throughout the year.

Saudi Arabia, which generates about 85% of total gross written premiums of all Islamic insurers in the GCC, experienced declines in premium income in motor business by 2.9% in 2020 and 6.8% in first-quarter 2021, due to falling new car sales. Despite this, we anticipate that premiums in Saudi Arabia will increase by up to 5% in 2021 absent any major lockdowns. This will likely be driven by higher premium volumes for medical business through an extension of existing and new covers and if public hospitals--which historically have not charged insurers for their services--start billing insurers and some existing covers are extended to a wider population.

Although the UAE, home to the second-largest Takaful market in the GCC, is experiencing a noticeable increase in consumer confidence due to higher oil prices, the rollout of vaccines against COVID-19, and changes in visa requirements to attract more talent, we anticipate that premium income in the market will be flat in 2021 from ongoing pressure on motor and other rates. A pickup in tourism and the start of Expo in Dubai in October 2021 could lead to additional business, but we believe some of the larger conventional insurers will benefit more than many of the smaller takaful players. We also expect that gross written premiums/contributions will overall be relatively flat or even slightly decline in the remaining GCC markets in 2021, due to weaker demand.

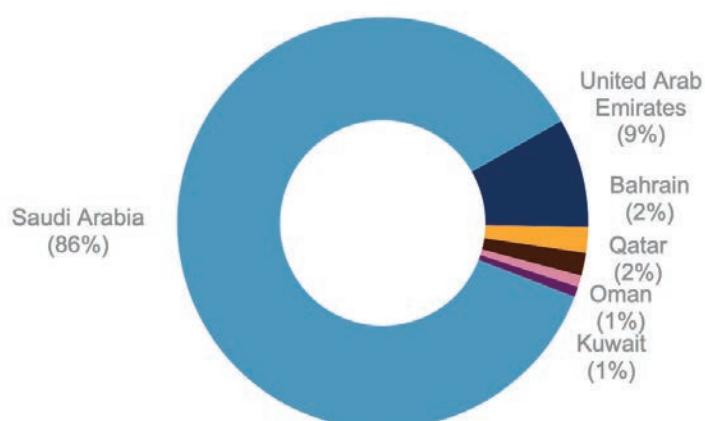
**Chart 1 - GCC Islamic Insurance Industry Gross Written Premiums/Contributions, 2019-2021f**



f--Forecast. Source: S&P Global Ratings.

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**Chart 2 - Islamic Insurance Industry Estimated Gross Written Premiums/Contributions By GCC Country, 2020**



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## Strong Improvements In Profitability Are Likely Not Sustainable

Both Takaful and conventional insurers in the region have benefited from either no or only modest exposure to COVID-19-related claims. This led to strong improvement in operating performance in 2020, since most governments in the GCC cover pandemic-related medical claims. At the same time, movement restrictions led to fewer nonessential hospital visits and motor claims. Based on our calculations, Takaful insurers in the GCC recorded a significant improvement in net income of about 67% in 2020 compared with 2019. This improvement was mainly driven by stronger underwriting results.

The resumption of nonessential medical treatment has caused claims to rise to more normal levels in the first part of 2021, and we expect this to continue over the next year. For example, the loss ratio for medical business in Saudi Arabia increased to 88.3% in first-quarter 2021 from 85.9% for the same period in 2020. Nevertheless, the net income for the industry in Saudi Arabia improved by 27% and about 36% for the whole Takaful industry in the GCC in first-quarter 2021 year on year. Unlike in 2020, when profitability was mainly driven by underwriting results, this improvement was largely supported by stronger investment returns, which for example improved by about 55% or Saudi Arabian riyal 100 million (about \$26.7 million) for first-quarter 2021 year on year. Although underwriting results will likely remain overall profitable in 2021, we expect a decline in earnings.

We expect that growth and earnings will not be evenly distributed, because the trend from recent years suggests large insurers are getting larger in terms of premiums, market share, and profits. For example, the top 5 insurers in Saudi Arabia generated about 68% of total premiums and almost all net profits in 2020. Smaller insurers have often been pushed to compete on price, which has hampered their profitability somewhat.

## Potential Asset Volatility Remains A Key Risk

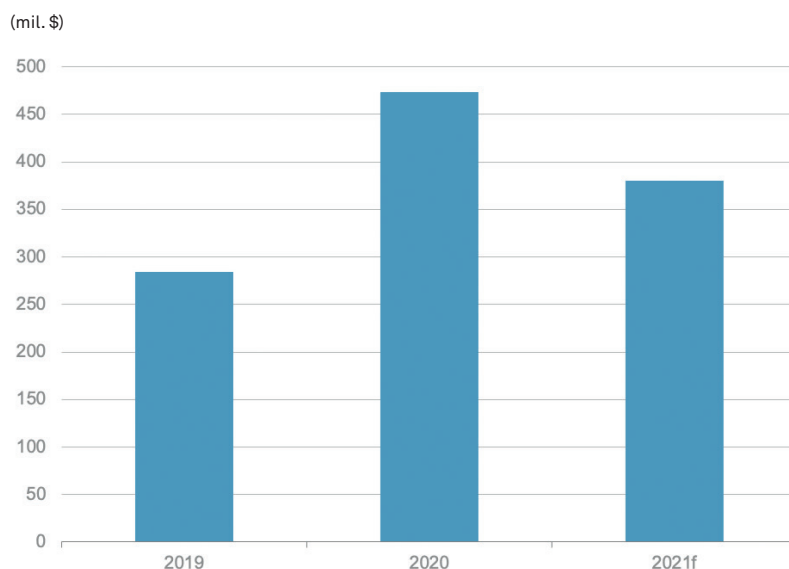
We consider asset volatility from investment results and a potential increase in premium receivables as a key risk for the earnings in the sector in 2021. Financial markets recovered in the second half of 2020 after a sharp drop following the COVID-19 outbreak, meaning that most Takaful companies could largely reverse some of the unrealized investment losses of up to 20% of shareholder equity for some entities that they accumulated earlier in the year. A decline in interest rates has prompted some Takaful players to further increase their exposure to equities or other high-risk assets in search of higher yields. Although equity markets had a strong start in most GCC countries in the first part of 2021, a potential return of volatility in capital markets could negatively affect earnings and capital of insurers with significant exposure to market risk.

A slow collection of receivables could also become an increasing issue for some insurers, depending on their portfolio and client mix. We anticipate that premium collections will remain slow for some insurers as businesses and governments delay their payments in an attempt to manage cash flows. This will lead to increased receivables and potential write-offs, further stressing liquidity, earnings and capital, and, consequently, credit conditions for some insurers.

## Industry Consolidation Could Accelerate Further

High valuations, ongoing shareholder support even for loss-making companies, and the absence of regulation that supports mergers or runoffs has hindered consolidation among insurers in some GCC markets. However, intense competition, stricter regulations, and certain regulatory benefits will result in further consolidation in the sector following mergers in a number of markets in recent years, in our view. Although scale is no guarantee for profitability, it helps, for example, insurers to dilute some fixed costs, which for many companies in the sector are relatively high. Following some recent merger announcements in Saudi Arabia, we expect further consolidation in the sector in 2021,

**Chart 3 - Net Income In The Islamic Insurance Industry In The GCC 2019-2021f**



f--Forecast. Source: S&P Global Ratings.

given that about one-third of the 30 active primary insurers are still posting losses. While only two of nine listed Takaful operators in the UAE recorded a net loss in 2020, we estimate that one-third of Takaful player in the country does not meet the solvency regulations that were adopted in early 2018 and that these companies will need to take action to restore their capital levels in the near future. Similarly, companies in Kuwait will need to fully implement all aspects of the new insurance law within a year of its publication in March 2021. This law makes it likely that higher reserving requirements will put further pressure on many smaller and unprofitable Takaful operations to comply with applicable regulations. Like in previous years, we expect that some insurers with weaker capital buffers will need to either raise additional capital or consolidate.

*This report does not constitute a rating action.*



# Sharjah Sukuk Programme Ltd. Senior Unsecured Debt Affirmed At 'BBB-/A-3' On Update Of Program Terms And Conditions

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This report is based on information as of July 5, 2021. This report does not constitute a recommendation to buy, hold, or sell securities.

DUBAI (S&P Global Ratings) July 5, 2021--S&P Global Ratings today affirmed its 'BBB-/A-3' long- and short-term ratings on the senior unsecured debt issued by Sharjah Sukuk Programme Ltd. (SSPL).

SSPL is a limited liability company of the government of Sharjah (BBB-/Stable/A-3), registered in the Cayman Islands, and established solely to issue Sharia-compliant securities in any currency. Under the transaction documents, SSPL will issue certificates based on, among other contracts, a master and supplementary lease agreement, master Murabaha agreement, and a purchase undertaking with government of Sharjah. The proceeds of the sukuk will ultimately be used for the government of Sharjah's funding purposes.

Sukuk issuance under the program is made using a structure that comprises two stages: a Murabaha contract using commodities as underlying assets (up to 49%), and a sale and purchase agreement of tangible assets (typically land plots) constituting not less than 51% of the principal throughout the life of the sukuk (55% at initial issuance). SSPL has amended and restated the terms and conditions of the sukuk program. This was largely to align them with the

Accounting and Auditing Organization for Islamic Financial Institutions' requirements, which are mandatory in the United Arab Emirates.

### ***The revised legal documents continue to fulfill the five conditions of our criteria for rating the sukuk program at the same level as the obligor, Sharjah:***

- The government of Sharjah's contractual obligations are sufficient to ensure full and timely payments of the periodic distribution amounts (through the lease agreement and profit of the Murabaha) and final payments of the principal amount (on the scheduled dissolution date or in case of early dissolution, through the purchase undertaking and the deferred Murabaha sale price). We expect this calibration to be maintained under each and every drawdown otherwise it could lead to a different rating.
- The government of Sharjah's obligations under the sukuk's terms will rank pari passu with its other senior unsecured financial obligations.
- Sharjah's obligations under the transaction documents are irrevocable.

- The government of Sharjah commits to fully and unconditionally cover all the costs related to the transaction through the servicing agency agreement and the various contracts related to the sukuk issuance, for the benefit of SSPL.
- Although the documentation mentions a total loss event (TLE) and a partial loss event (PLE), we consider the

risk stemming from both as remote since Sharjah will use land assets as underlying assets for any drawdown. We would assess the TLE/PLE risk for each drawdown separately and may assign a different rating if, in our view, these risks are not remote. This is because, in our opinion, investors could be subject to residual asset risks as the obligations of Sharjah to repay investors under a TLE/PLE scenario could be challenged.

## Transaction Details

Issuer, trustee, purchaser, lessor	Sharjah Sukuk Programme Limited
Obligor, seller, lessee, buyer, servicing agent and the government	The Government of the Emirate of Sharjah, acting through the Sharjah Finance Department
Arranger	HSBC Bank plc, Standard Chartered Bank
Principal paying agent and transfer agent	Deutsche Bank AG, London Branch
Delegate	Deutsche Trustee Company Ltd.
Governing law and dispute resolution	English law

We continue to equalize our rating on the program with our issuer credit ratings on Sharjah. We will review the legal documentation of each new drawdown. A material change in the contractual obligations or our assessment of PLE and TLE risks could affect the rating on that specific drawdown. S&P Global Ratings neither structures sukuk transactions nor provides opinions about the compliance of the transaction with Sharia. This report does not constitute a recommendation to buy, hold, or sell the trust certificates.

**Changes to legal documents expose investors to residual asset risk.** Under the servicing agency agreement, there is now an obligation to maintain a tangibility ratio higher than 50% of the total value of the underlying assets throughout the lifetime of the transaction. If the ratio drops below 50% and remains above 33% (other than in a case of a TLE) and, as a result, the performance of the underlying assets cannot cover the periodic distribution amount, we rate to the assumption that if this underperformance is not covered by the optional liquidity facility, the transaction's early dissolution will be triggered. If the tangibility ratio falls below 33%, investors will receive an option to request the early repayment of the sukuk at a price that will include, among other things:

- The total face amount of the certificates where an early repayment was requested; plus
- All accrued-but-unpaid periodic distribution amounts related to these certificates; plus

- Any amount payable by the trustee under the transaction documentation and the terms and conditions related to these certificates; minus
- The amounts outstanding of the deferred payment price related to these certificates that will be collected through the Murabaha contract.

The certificates will also be delisted if the tangibility ratio falls below 33%. The exercise of the purchase undertaking, at maturity, or an early dissolution or tangibility event, will result in the issuer receiving an amount sufficient for the full (or proportional in case of tangibility event) redemption of the sukuk certificates. We also understand that the underlying assets will only be valued on the date of any program drawdown or in case of replacement, which minimizes to some extent the risk of a tangibility event.

**The updated legal documents introduce the notion of a PLE (partial loss event).** A PLE is triggered if there has been a partial impairment of one or more lease assets in a manner that substantially deprives the lessee of its use and enjoyment. Although the service agent (Sharjah) is obliged to properly insure the underlying assets, we think that investors can still be exposed to residual asset risk stemming from Sharjah's capacity to challenge the legality of the obligations to insure, given the described terms and conditions of the insurance coverage in the legal documents. As such, we rate the program under the assumption that a PLE is remote. This is underpinned by our understanding that the underlying assets for any drawdown will comprise land assets. In each drawdown,

we will reassess this assumption. If a PLE occurs while any issuance is outstanding, the rating on that drawdown could be subject to multi-notch transition risk (see paragraph 22 of “General Criteria: Methodology For Rating Sukuk,” published Jan. 19, 2015, on RatingsDirect).

**Investors ranking in a default scenario could be challenged.** The master declaration of trust specifies that if SSPL fails to fulfill its obligations under the purchase undertaking, the government of Sharjah shall, as an independent, severable, and separately enforceable obligation, fully indemnify the issuer for the purpose of redemption of the certificate.

However, the master declaration of trust and purchase undertaking now makes this indemnity and execution of the exercise price conditional on the government of Sharjah (acting in any capacity) being in actual or constructive possession, custody, or control of all or any part of the lease assets. We note that under the master lease agreement, Sharjah has the obligation to maintain actual or constructive possession, custody, or control of all the lease assets. Notwithstanding that the legal documents stipulate that all obligations of Sharjah are unsubordinated and unsecured, if the indemnity obligation is altered in future updates of the legal documents or for a specific drawdown, our view of the ranking of the sukuk creditors in the event of a default of the sponsor might change. This could negatively affect the rating on the program and its drawdowns.

## Related Criteria

- Criteria | Governments | Sovereigns: Sovereign Rating Methodology, Dec. 18, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Methodology For Rating Sukuk, Jan. 19, 2015
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

## Related Research

- Research Update: Emirate of Sharjah ‘BBB-/A-3’ Ratings Affirmed; Outlook Stable, April 24, 2021
- Research Update: Sharjah Downgraded To ‘BBB-’ On Increased Risks To Its Fiscal Position; Outlook Stable, Oct. 24, 2020
- Sharjah Sukuk Programme Issuance Assigned ‘A-2’ Short-Term Rating, June 2, 2020
- Research Update: Emirate of Sharjah Downgraded To ‘BBB’ On Increasing Debt And Interest Burden; Outlook Stable, Feb. 15, 2020
- Presale: Sharjah Sukuk Programme Limited, Feb. 16, 2018
- Sharjah Sukuk Programme Limited Assigned Preliminary ‘BBB+’ Rating, Feb. 16, 2018
- Research Update: Emirate of Sharjah ‘BBB+/A-2’ Ratings Affirmed; Outlook Stable, Jan. 20, 2018

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. A description of each of S&P Global Ratings’ rating categories is contained in “S&P Global Ratings Definitions” at [https://www.standardandpoors.com/en\\_US/web/guest/article/-/view/sourceld/504352](https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceld/504352) Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings’ public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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This presale report is based on information as of June 29, 2021. This report does not constitute a recommendation to buy, hold, or sell securities. Final ratings will depend upon receipt and satisfactory review of all final transaction documentation, including legal opinions. Accordingly, this presale report should not be construed as evidence of final ratings. If S&P Global Ratings does not receive final documentation within a reasonable time frame, or if final documentation departs from materials reviewed, S&P Global Ratings reserves the right to withdraw or revise its ratings.

## Profile

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

## Transaction

PD Sukuk Ltd. (PD Sukuk), an orphan special-purpose vehicle incorporated in the Cayman Islands, plans to establish a US\$1 billion sukuk (trust certificates) program for Private Department of Skh Mohamed Bin Khalid Al Nahyan LLC (PD). The proposed inaugural sukuk issuance under the program is intended to repay existing bank debt and fund general corporate needs.

All sukuk issuance under the program will be made using a Wakala structure that comprises two legs: a Murabaha contract, and a sale and purchase agreement of real estate assets. We understand that PD is using this structure to raise funds in compliance with Sharia law. The underlying Wakala assets will be certain income-generating real estate assets in Abu Dhabi (the Wakala Assets), owned by PD (not less than 51% of the principal) and commodities (up to 49%). Under the transaction, PD will sell the beneficial interest related to the pool of assets to PD Sukuk.

## Rationale

The rating on the sukuk program reflects the rating on PD Sukuk Ltd. (BB/Stable/--) because the proposed transaction fulfills the five conditions of

our criteria for rating sukuk (for more information, see "Methodology For Rating Sukuk," published Jan. 19, 2015, on RatingsDirect):

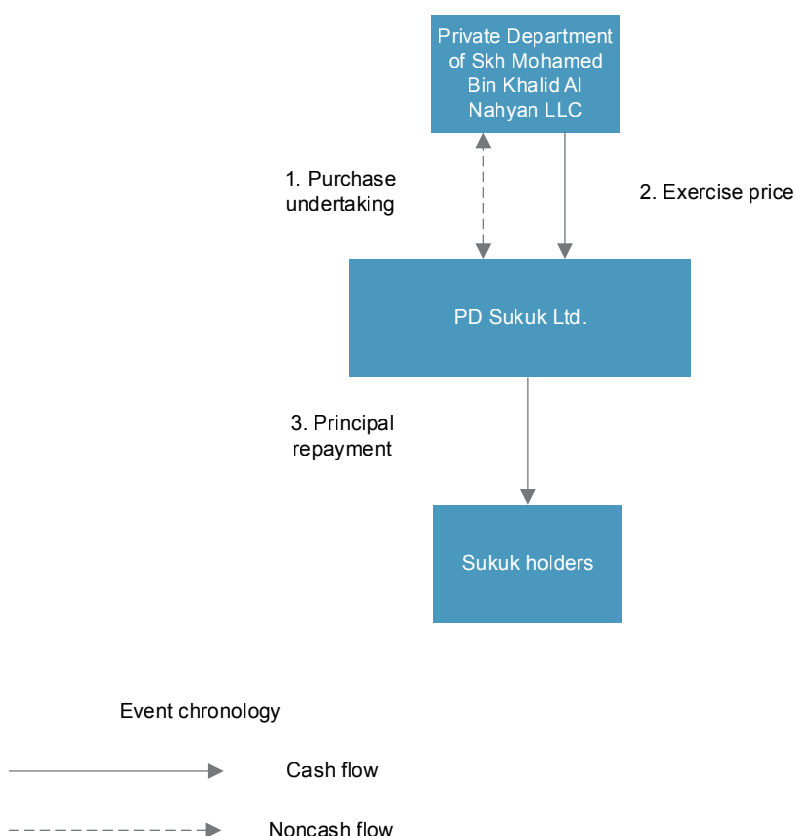
- PD will provide sufficient and timely contractual obligations for the timely repayment of the principal amount and the final periodic distribution amount in case of shortfall in the performance of the underlying assets leading to an early dissolution of the sukuk.
- The company's obligations under the transaction documents are irrevocable.
- These obligations will rank pari passu with PD's other senior unsecured financial obligations.
- PD will undertake to cover all the costs related to the transaction, through the service agency agreement and the exercise price payable for the benefit of PD Sukuk.
- Although the documentation mentions a risk of a total loss event (TLE), we view this possibility as remote and rate to this assumption. Our opinion is underpinned by our understanding that the portfolio of underlying assets will be diversified, with real estate assets in Abu Dhabi (for at least 51% of the underlying assets).

We therefore equalize the rating on the sukuk with the long-term issuer credit rating on PD. We understand that first issuance under the program will be \$600 million to repay existing bank debt and fund general corporate needs.

Table 1 - PD Sukuk Ltd. Transaction Details

Issuer, trustee	PD Sukuk Ltd.
Sponsor	Private Department of Skh Mohamed Bin Khalid Al Nahyan LLC
Arrangers	Emirates NBD Capital
Principal paying agent	Citibank N.A., London Branch
Delegate	The Law Debenture Trust Corp. PLC
Governing law	English

Chart 1 - Principal Repayment



Source: S&P Global Ratings.  
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### A sukuk structure provides sufficient contractual obligations for full and timely repayment

The transaction involves a special-purpose vehicle incorporated under the laws of the Cayman Islands, issuing rated sukuk trust certificates. Sukuk proceeds will be used to acquire a portfolio of Sharia-compliant assets that PD will manage (as service agent). On the sukuk's issue date, PD Sukuk will purchase from PD the beneficial interests in a portfolio of identified income-generating real estate assets also, through a commodity agent, certain Sharia-compliant commodities.

Under the transaction documentation, revenue from the portfolio of income-generating real estate assets (consisting of residential towers leased to tenants, including the land plot) together with instalment amounts constituting the deferred payment price payable under the Murabaha contract, will pay the periodic distribution amounts on the sukuk. In case of a shortfall between the assets' revenue and the periodic distribution amount, PD can provide liquidity support or arrange for support to the issuer by a third party. While legally PD is not obliged to provide this, we understand that failure to do so would result in the sukuk's early dissolution as one of the periodic distributions amounts could be missed.

At the transaction's maturity or upon a dissolution event (the definition of which excludes TLE), PD, under the purchase undertaking, will purchase the Wakala assets. The exercise price will include among others:

- The total face amount of the certificates outstanding; plus
- All accrued-but-unpaid periodic distribution amounts; plus
- Any amount payable by the trustee under the transaction documentation; minus
- The amounts outstanding of deferred payment price that will be collected through the Murabaha contract.



If a dissolution event occurs, although the trustee (the issuer) or the delegate will deliver an exercise notice under the purchase undertaking to PD declaring that the exercise price should become immediately due and payable, this payment will happen only on the dissolution date, which the delegate sets. We could lower our ratings on PD (as the obligor) and the sukuk to 'D' (default) or 'SD' (selected default) should this payment not occur in a timely manner, as we define timeliness (see paragraphs 11 and 12 of our sukuk criteria).

Due to the United Arab Emirates' adoption of AAOFI's standards, the transaction documentation require tangible assets to remain above 50% of the total assets in the portfolio underlying any issuance, throughout the transaction's lifetime. If the tangibility ratio falls below 50% (other than in a case of a TLE) and, as a result, the performance of the underlying assets cannot cover the periodic distribution amount, we rate to the assumption that if this underperformance is not covered by the optional liquidity facility, the transaction's early dissolution will be triggered. If the tangibility ratio falls below 33%, investors will receive the option to request the early repayment of the sukuk at a price that will include, among others:

- The total face amount of the certificates where an early repayment was requested; plus
- All accrued-but-unpaid periodic distribution amounts related to these certificates; plus
- Any amount payable by the trustee under the transaction documentation and the terms and conditions related to these certificates; minus
- The amounts outstanding of deferred payment price, related to these certificates, that will be collected through the Murabaha contract.

The certificates will also be delisted if the tangibility ratio falls below 33%.

The exercise of the purchase undertaking, at maturity, or an early dissolution or tangibility event will result in the issuer receiving an amount sufficient for the full (or proportional in case of tangibility event) redemption of the sukuk certificates.

The master declaration of the trust specifies that if PD fails to fulfill its obligations under the purchase undertaking, the company will, as an independent, severable, and separately enforceable obligation, fully indemnify the issuer for the purpose of redeeming the certificate (in full or proportionally in case of tangibility event) under the condition that PD (acting in any capacity) is in actual or constructive possession, custody, or control of all or some lease assets. This is also an obligation that PD undertook (as a service agent) to fulfill under the service agency agreement. This conditionality was added to ensure the transaction's Sharia compliance. Because the underlying assets will not effectively be transferred to the issuer, we believe this condition will be fulfilled during the transaction's lifetime. If it is not fulfilled for any reason, PD would not be able to execute the obligation to indemnify and the ranking of investors in a liquidation scenario of PD could be affected. This would have an impact on the sukuk rating.

## Total Loss Event

Although the transaction documentation mentions the risk of a TLE, we view this as unlikely and rate to this assumption. Our opinion is underpinned by our understanding that the portfolio of underlying assets will include a diversified portfolio of real estate assets in Abu Dhabi (for at least 51% of the underlying assets). PD's legal obligations under the transaction documents might leave investors exposed to residual assets risks. The company must ensure that the assets are covered by insurance, in addition to the obligation to make up any shortfall between insurance proceeds and the principal amount, under a TLE scenario, unless it proves beyond any doubt that it has complied with its insurance obligations. This exclusion might leave investors exposed should a TLE occur.

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

### Related Criteria

- 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
- Criteria | Corporates | Industrials: Key Credit Factors For The Real Estate Industry, Feb. 26, 2018
- Criteria | Corporates | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- General Criteria: Methodology For Rating Sukuk, Jan. 19, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

### Related Research

- Private Department of Skh Mohamed Bin Khalid Al Nahyan LLC Assigned 'BB' Rating; Outlook Stable, July 5, 2021
- External Auditing Of Sharia Compliance Will Likely Strengthen Governance In Islamic Finance, May 24, 2021

# Emaar Sukuk Ltd.'s Program Affirmed At 'BB+' On Update Of Sukuk Terms And Conditions

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S&PGR Affirmed Emaar Sukuk Ltd.'s Program At 'BB+'

DUBAI (S&P Global Ratings) June 28, 2021--S&P Global Ratings today affirmed its 'BB+' rating on Emaar Sukuk Ltd.'s (ESL's) \$2 billion sukuk program.

ESL is a limited liability company registered in the Cayman Islands with issued shares held in trust by Maples FS Ltd. ESL amended and restated the terms and conditions of the sukuk program largely to align them with the new Sharia requirements in the United Arab Emirates.

Among the changes, there is now an obligation to maintain a tangibility ratio (ratio of the value of the lease assets as a proportion of the sukuk total value) above 50% throughout the lifetime of the transaction. If the tangibility ratio falls to 50% or below, but remains above 33%, Dubai-based property company Emaar Properties PJSC (EP; BB+/Stable/--), as the servicing agent, shall take steps, in consultation with its Sharia adviser, to ensure that the ratio is restored to more than 50% within the period determined by the adviser. If the ratio falls below 33%, a tangibility event occurs in which, among other things, ESL's certificates are delisted, while certificate holders are given the option to request early repayment of their sukuk. If a tangibility event occurs, and assuming a large percentage of the investors exercise their early dissolution option, EP could face heightened liquidity strain, in our view.

The update of the legal documents also includes the introduction of partial loss event (PLE) risk. A PLE is triggered if there has been a partial impairment of lease asset(s) in a manner that substantially deprives the lessee of its use and enjoyment of the lease assets. Although the service agent is obliged to properly insure the underlying assets, we think that investors can still be exposed to residual asset risk stemming from the capacity of EP to challenge the legality of the obligations to insure, given the described terms and conditions of the insurance coverage in the legal documents. As such, we rate the program under the assumption that a PLE is remote. This is underpinned by our understanding that the underlying assets for any drawdown will comprise land assets. In each drawdown, we will have to reassess this assumption. If a PLE occurs while any issuance is outstanding, the rating on that drawdown could be subject to multi-notch transition risk (see paragraph 22 of "General Criteria: Methodology For Rating Sukuk," published Jan. 19, 2015, on RatingsDirect).

The revised legal documents continue to fulfill the five conditions of our criteria for rating sukuk:

- EP's contractual obligations will be sufficient to repay the principal amount and the periodic distributions in full and on time. The principal will be paid from a combination of the exercise price under the purchase undertaking and the deferred price under the murabaha agreement.

The periodic distributions will be paid from the lease charge that EP will pay under the Ijara contract and the profit element of the murabaha agreement. We understand that the sum of these will be calibrated to match the periodic distribution amount exactly. Should this calibration not hold under a drawdown of this program, we may assign a different rating.

- EP's obligations under the sukuk's terms and conditions are irrevocable and will rank pari passu with EP's other senior unsecured financial obligations.
- EP will undertake to cover all the costs related to the transaction through the servicing agency agreement and the various contracts related to the sukuk issuance for the benefit of ESL.
- Although the documentation mentions a total loss event (TLE), we consider a TLE risk as remote since EP will use land assets as underlying assets for any drawdown. Like PLE risks, we would assess the TLE risk for each drawdown separately and may assign a different rating if, in our view, these risks are not remote. This is because, in our opinion, investors are still subject to residual asset risks as the obligations of EP to repay investors under a TLE scenario could be challenged in the same way as for a PLE (see above).

The master declaration of the trust specifies that if EP fails to fulfill its obligations under the purchase undertaking, the company shall, as an independent, severable, and separately enforceable obligation, fully indemnify the issuer for the purpose of redemption of the certificate under the condition that EP (acting in any capacity) is in actual or constructive possession, custody or control of all or any part of the lease assets. We note that EP has undertaken to maintain such possession, custody and control under the master lease agreement. Notwithstanding that the legal documents stipulate that all obligations of the sponsor are senior unsecured, if this obligation is altered in future updates of the legal documents or for a specific drawdown, our view of the ranking of the sukuk creditors in the event of liquidation of the sponsor might change. This could negatively affect the rating on the program and its drawdowns.

We continue to equalize our rating on the program with our long-term issuer credit rating on EP. We will review the legal documentation of each new drawdown and, a material change in the contractual obligations or our assessment of TLE and PLE risks could affect the rating on that specific drawdown. S&P Global Ratings neither structures sukuk transactions nor provides opinions about the compliance of the transaction with Sharia.

## Related Criteria

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- Criteria | Corporates | Industrials: Key Credit Factors For The Real Estate Industry, Feb. 26, 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 Homebuilder And Real Estate Developer Industry, Feb. 3, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

## Related Research

- Dubai-Based Real Estate Developer Emaar Properties Outlook Revised To Stable From Negative On Stronger Demand, June 27, 2021
- Full Analysis: Emaar Properties PJSC, Sept. 1, 2020

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at [https://www.standardandpoors.com/en\\_US/web/guest/article/-/view/sourceld/504352](https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceld/504352) Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.



# Transaction Update: Malaysia Wakala Sukuk Bhd.

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## Profile

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

## Transaction Summary

This post-sale report is based on information dated April 28, 2021, and is posted in conjunction with the issuance of US\$1.3 billion sukuk (trust certificates) by Malaysia Wakala Sukuk Bhd., a financing vehicle for the government of Malaysia (foreign currency A-/Negative/A-2; local currency A-/Negative/A-1). Malaysia Wakala Sukuk Bhd. will enter, among other contracts, into a voucher purchase agreement, a purchase undertaking, and a wakala agreement with the government of Malaysia.

## Rationale

The rating on the sukuk reflects the foreign currency sovereign credit rating on Malaysia. That's because the transaction fulfills the five conditions of our criteria for rating sukuk at the same level as the sponsor:

- The government of Malaysia will provide sufficient and timely contractual obligations for the payment of the periodic distribution amounts and the principal amount. The former is covered through the obligation of the government of Malaysia to sell a specific quantity of vouchers at a specific price that would be sufficient to pay the periodic distribution amounts. If the government fails to sell a quantity of vouchers sufficient to fund the periodic distribution payment, it will either purchase the remaining vouchers as part of its obligations under the purchase undertaking or will have an indemnity obligation to make up any resulting shortfall from selling the vouchers at a lower-than

expected price. The principal amount is covered through the undertaking by the government of Malaysia to buy back the underlying assets at a sufficient price;

- These obligations are irrevocable;
- These obligations will rank pari passu with the government of Malaysia's general obligations;
- Under the agency agreement, the government of Malaysia will undertake to cover all the costs related to the transaction; and
- We assess as remote the risks that a total loss event jeopardizes the full and timely repayments of the sukuk. While a revocation event is mentioned in the legal documents, our opinion is based on the unconditional obligations of the government of Malaysia to buy back the underlying assets at a sufficient price to pay back the investors in case of a revocation event. We also assess the probability of such an event as remote. Finally, the legal documents mention the possibility of substituting the underlying assets without clarifying the nature of the potential new assets, besides their tangibility. In case of substitution, S&P Global Ratings will assess the impact on the risk profile of the transaction and the potential exposure of investors to residual assets risks.

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

**Issuer and trustee**

Malaysia Wakala Sukuk Bhd., incorporated in Malaysia.

**Seller of the vouchers**

The government of Malaysia.

**Wakeel and buyer of the underlying assets**

The government of Malaysia.

**Periodic distribution rate**

Semi-annual fixed profit rate determined at the closing of the transaction.

**Joint lead managers**

CIMB Investment Bank Bhd.; The Hongkong and Shanghai Banking Corp. Ltd.; and J.P. Morgan Securities PLC

**Principal paying and transfer agent**

The Hongkong and Shanghai Banking Corp. Ltd.

**Governing law**

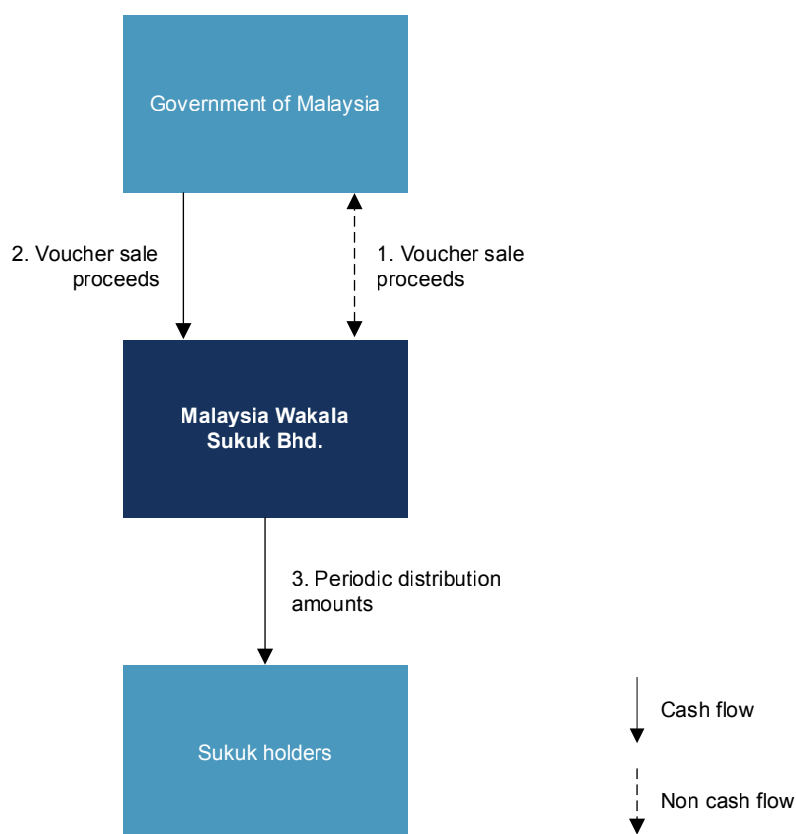
English law and Malaysian law.

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

The transaction involves a special-purpose company incorporated in Malaysia, issuing rated sukuk trust certificates. The proceeds of the sukuk will ultimately be used to acquire travel vouchers, to be managed by the government of Malaysia (the wakeel). The vouchers will represent entitlements to a specified number of travel units. Under the sukuk terms and conditions, the proceeds from the sale of vouchers, shall be sufficient to pay the periodic distribution amount. In case of shortfall between the sales proceeds of the vouchers and the periodic distribution amount, the Malaysian government will either purchase the remaining vouchers as part of its obligations under the purchase undertaking or will have an indemnity obligation to make up any resulting shortfall from selling the vouchers at a lower-than-expected price.

The government of Malaysia, as wakeel, will pay the necessary amount in a timely manner to allow the issuer to pay the periodic distributions to the sukuk holders (see chart 1). These obligations are unconditional and will rank pari passu with the government of Malaysia's other general obligations.

**Chart 1 - Malaysia Sukuk Bhd.  
Periodic distributions**

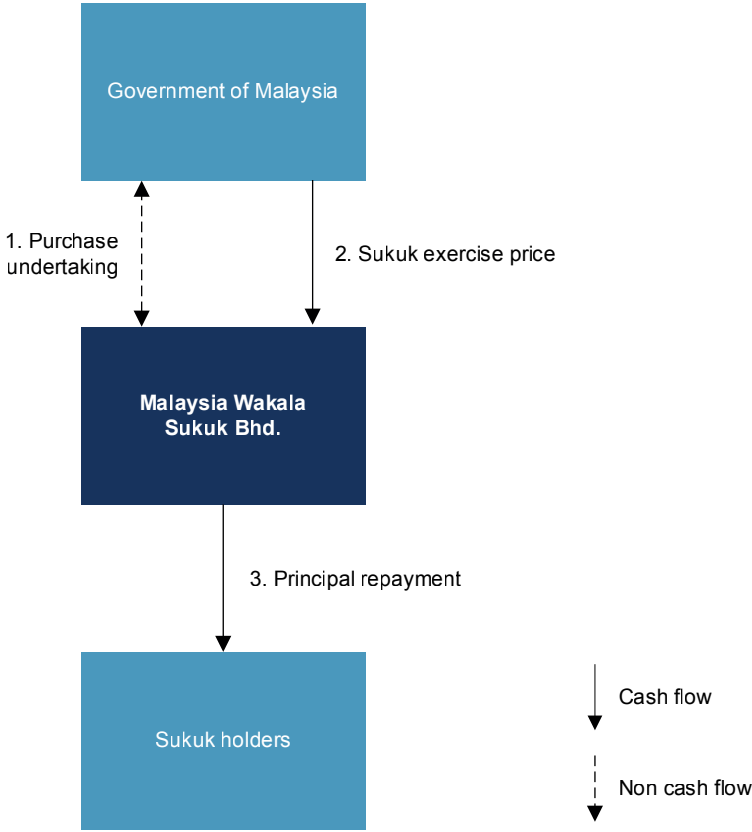


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At the maturity date of the transaction or upon the occurrence of a dissolution event, the government of Malaysia will buy back the wakala sukuk assets for a price equivalent to the sum of the following: principal amount of the sukuk; all accrued and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

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

Chart 2 - Malaysia Sukuk Bhd.  
Principal repayment



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Total Loss Event

We assess as remote the risks that a total loss event jeopardizes the full and timely repayments of the sukuk. While a revocation event is mentioned in the legal documents, our opinion is based on the unconditional obligations of Malaysia to buy back the underlying assets at a sufficient price to pay-back the investors in case of revocation event. We also assess the probability of such event as remote. Additionally, the legal documents mention the possibility of substituting the underlying assets without clarifying the nature of the potential new assets, besides their tangibility. In case of substitution, S&P Global Ratings will assess the impact on the risk profile of the transaction and the potential exposure of investors to residual assets risks.

**Related Criteria**

- Criteria | Governments | Sovereigns: Sovereign Rating Methodology, Dec. 18, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Methodology For Rating Sukuk, Jan. 19, 2015
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

**Related Research**

- Malaysia Outlook Revised To Negative; 'A-/A-2' Foreign Currency And 'A/A-1' Local Currency Ratings Affirmed, June 26, 2020
- Presale: Malaysia Wakala Sukuk Bhd., April 19, 2021

Ratings Detail (As Of Apr 30, 2021)\*

Malaysia Wakala Sukuk Bhd.		
Senior Unsecured		A-

\*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

*This report does not constitute a rating action.*

# The U.K.'s Second Sukuk Issuance Is Positive For The Market But Not A Game Changer

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More than a year after the expiry of its 2014 £200 million sukuk, the U.K. has returned to the sukuk market with a new £500 million Ijara sukuk. However, market appetite for this second sukuk instrument was reportedly significantly below the level of the first sukuk issued in 2014, when it was 10x oversubscribed. The new sukuk was 1.25x oversubscribed (order book of £625 million). In 2014, there were a few investors who wanted to purchase the whole amount. The pricing of the latest issuance remained like that of conventional instruments, such as the 2014 issuance. In our view, such a low oversubscription rate this year can be explained by the instrument's low return and the fact that investors are actively hunting for higher yields.

**Key Takeaways**

- The U.K. has returned to the sukuk market with a £500 million sukuk, six years after its first issuance in 2014.
- Despite strong global liquidity, the subscription rate was reportedly significantly lower than the 2014 issuance.
- We expect the overall volume of activity in Islamic finance in the U.K. and Europe to remain small.

The sukuk's overall contribution to the financing of the U.K. government funding needs is small. However, that the U.K. has tapped the sukuk market again is a positive signal of its continued interest in the vehicle. S&P Global Ratings observes that other European sovereigns, particularly Luxembourg, are also showing interest. Nevertheless, we expect the overall volume of activity in Islamic finance in Europe and in the U.K. to remain small.

### **A £500 million Ijara sukuk**

The structure of the new sukuk is like that of the 2014 sukuk which used a type of sale/leaseback structure. The underlying assets include several office properties which are owned by the government. These buildings will be leased back to the U.K. government for a rental amount that is likely equivalent to the periodic distribution amount. At the maturity of the sukuk, a purchase undertaking will likely be executed to repay investors.

### **Wakala plus Murabaha is more widely used**

The Ijara structure is becoming less common in the global sukuk market. Issuers have shown preference for the hybrid Wakala structure, under which assets can be further leveraged by adding a Murabaha component. Once Wakala-structured transactions were issued, the tangibility ratio (tangible assets to total assets ratio) was predominantly complied with on a best-efforts basis. However, for countries that have adopted the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standards, maintaining the tangibility ratio is a requirement over the lifetime of the transaction, which causes some additional complexity and potential costs. It remains to be seen whether such complexity and costs will deter issuers' appetite for such structures or regulators' appetite to adopt the AAOIFI standards.

So far, maintenance of the tangibility ratio has been dealt with through revisions in the legal documents of some hybrid sukuk to incorporate the additional requirements. We have seen such changes take the form of an option or requirement to dissolve the sukuk if the tangibility ratio is not met. While early dissolution could resolve Sharia compliance-related issues, it increases the liquidity risk for corporate issuers using sukuk by increasing the risk related to the liquidation of their existing sukuk.

### **Negative periodic distribution rates might be challenging to implement**

Low interest rates and abundant liquidity continue to push down the pricing of some sukuk instruments. Although profit and loss sharing is one of the main principles of Islamic finance, we have not seen any instruments being issued with a negative periodic distribution rate.

### **Islamic finance will remain small in Europe and the U.K.**

In the current environment, we think that the structural complexity of many sukuk financings and strong international liquidity are deterring issuers. We therefore do not foresee any major increase in sukuk issuances in the U.K. or elsewhere in Europe in the next couple of years. Similarly, we do not foresee a significant increase in Islamic banking activities in the U.K. or Europe. Again, the complexity related to some of the transactions and sometimes their lack of competitiveness are the two major hurdles. At year-end 2019, the total assets of Islamic banks operating in the U.K. stood at around \$7.2 billion.

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*This report does not constitute a rating action.*

# Islamic Development Bank's \$25 Billion Trust Certificate Issuance Program Rating Affirmed at 'AAA'

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DUBAI (S&P Global Ratings) March 15, 2021-- S&P Global Ratings today affirmed its 'AAA' issue rating on Islamic Development Bank's (IsDB's) multi-currency fixed- or floating-rate \$25 billion sukuk trust certificate issuance program and the outstanding issuances under the program.

IsDB has incorporated two fully owned special purpose vehicles (SPV) for the sole purpose of issuing Sharia-compliant securities (sukuk or trust certificates) under the program. IDB Trust Services Ltd. and IsDB Trust Services No.2 SARL are incorporated with limited liability in Jersey and Luxembourg, respectively.

IsDB has updated its issuance program to include the more recently incorporated IsDB Trust Services No.2 SARL. The updated program includes a revision to the risk-free rates available to sukuk issued under the program and allows for taps on and repurchases of outstanding issuances. Changes to the program's structure include an increase to 51% from 33% of tangible assets in the portfolio of assets underlying any issuance and the removal of the concept of a maximum rate of return. The updates do not change our view on equalization with our rating on IsDB'. The updates will only affect new issuances under the program.

Under the transaction documents, IDB Trust Services Ltd. and IsDB Trust Services No.2 SARL can issue certificates based on, among other documents, a deed of guarantee and a purchase

undertaking deed. The SPVs will use the proceeds of the trust certificate issuance to purchase a portfolio of assets from IsDB, which IsDB will continue to administer. Income generated from the portfolio will fund the periodic distributions with any potential shortfall covered by a guarantee from IsDB. At the trust certificates' maturity, IsDB will repurchase the assets from the SPV, funding the principal payment. We understand that the sukuk proceeds will be used for IsDB's general funding purposes.

The guarantee also covers the performance of the assets in the portfolio. Should a tangible asset lose value, under the guarantee IsDB will cover for its performance as per the original contractual obligations. This would allow the transaction to have the necessary cash flows to replace assets should the tangibility ratio fall below 51%. Moreover, if the tangibility ratio drops below 51%, a dissolution event would be triggered and the principal payment and the amount of accrued but unpaid periodic distribution amounts on the relevant dissolution date would immediately become due.

The 'AAA' rating on the sukuk program reflects the rating on IsDB, because we expect transactions under the program to meet 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). This is because:



- IsDB will provide sufficient and timely contractual obligations for the repayment of the periodic distribution amounts (under the deed of guarantee) and the principal amount (through the purchase undertaking);
- These obligations will rank pari passu with all other outstanding senior unsecured obligations;;
- IsDB's obligations are irrevocable and unconditional;
- IsDB will undertake to cover all costs related to the transaction through various obligations under the different contracts; and
- There is no total loss event defined as part of the legal documentation of the program.

We therefore continue to equalize our rating on the program with our issuer credit rating on IsDB. We base this rating action on the sukuk program on final documentation. However, we will review the legal documentation of each new drawdown and, if there is a material change in the contractual obligations or our assessment of total loss event risks, the rating assigned may be different from the program rating. S&P Global Ratings neither structures sukuk transactions nor provides opinions about the compliance of the transaction with Sharia.

### Related Criteria

- Criteria | Governments | General: Multilateral Lending Institutions And Other Supranational Institutions Ratings Methodology, Dec. 14, 2018
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- General Criteria: Methodology For Rating Sukuk, Jan. 19, 2015
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

### Related Research

- Global Sukuk Issuance Is Set To Increase In 2021, Jan. 12, 2021
- Islamic Development Bank, Nov. 30, 2020
- Islamic Development Bank 'AAA/A-1+' Ratings Affirmed; Outlook Stable, Nov. 21, 2019

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at [https://www.standardandpoors.com/en\\_US/web/guest/article/-/view/sourcelid/504352](https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourcelid/504352) Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

# Transaction Update: International Islamic Liquidity Management 2 SA

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**\$4.0 Billion Short-Term Trust Certificate Issuance Program**  
Dec 18, 2020

## Ratings Detail

### Ratings List

Program	Rating*	Program limit (bil. \$)	Administrator	Type of conduit
International Islamic Liquidity Management 2 SA	A-1 (sf)	4.0	International Islamic Liquidity Management Corp.	Multiseller

\*S&P Global Ratings' credit rating addresses timely payment of the target profit amount and ultimate principal.

### Program Participants

Sponsor/administrator/investment advisor	International Islamic Liquidity Management Corp.
Account provider	Citibank Europe PLC
Issuing and paying agent, calculation agent, and transfer agent	Citibank N.A. London Branch
Liquidity facility providers	Committed investors rated at least 'A'
Arranger	International Islamic Liquidity Management Corp.
Custodian	Citibank N.A., Hong Kong Branch

### Supporting Ratings

Institution/role	Rating
Underlying sukuk assets	At least 'A'
Committed investors as liquidity facility providers	Highest rated counterparty (at least 'A') under the joint and several commitment
Citibank Europe PLC as account bank	A+/Stable/A-1

## Program Key Features

Initial rating date	April 4, 2013
Securities offered	Short-term Sharia-compliant certificates with a maximum tenor of 364 days. Certificates are denominated in U.S. dollars and have a fixed target profit amount.
Type of conduit	Multi-seller, fully supported program. The program does not have post-review status for any assets.
Maximum program limit (bil. \$)	4.0
Collateral	Sovereign, sovereign-linked, or supranational sukuk assets whose long-term rating is at least 'A' from S&P Global Ratings. The 'A' rating is the long-term equivalent of the 'A-1 (sf)' rating on the program.
Asset-specific liquidity support	In the event the issuer is unable to roll certificates, to address timing mismatch between the cash flows on the assets and the certificates, liquidity is provided through a combination of early prepayment features for certain assets and from committed investors with a joint and several commitment with at least one counterparty rated at least 'A' (see "Asset-specific liquidity support").
PWCE	There is no minimum PWCE requirement since the conduit meets the definition of a small asset portfolio under our PWCE criteria (see "Programwide credit enhancement").
Cash reserve	The vehicle benefits from a reserve equal to 2% of the aggregate maturity amounts of all certificates then outstanding.

PWCE--Programwide credit enhancement.

## Transaction Summary

S&P Global Ratings is publishing this transaction update as part of our ongoing surveillance of International Islamic Liquidity Management 2 SA's (IILM) short-term trust certificates program.

We initially rated the program on April 4, 2013 (see "International Islamic Liquidity Management 2 SA's US\$500 Million Landmark Islamic Finance Program Assigned 'A-1' Rating"). IILM is a commercial paper program established to issue short-term Sharia-compliant money-market instruments backed by long-term sovereign, sovereign-linked, or supranational sukuks. This program is used to create a high-quality widely accepted Sharia-compliant liquidity management tool for Islamic banks that have limited short-term investment options. In September 2020, the program issuance limit was increased to \$4.0 billion from \$3.0 billion to cater for a growing asset pool.

The liquidity support for the rated certificates is currently provided through an early prepayment feature on each of the funded assets, which IILM can exercise with five business days' notice. For any future sukuks that do not contain an early prepayment feature, there remains a joint and several commitment from committed investors to purchase match funded certificates from IILM. The available aggregate liquidity amount will be equal to at least 100% of the certificates outstanding.

Our rating on IILM's short-term trust certificates program is based on a weak-link principle between the credit quality of each underlying asset and the committed investors as liquidity support providers (see "Assessing

Credit Quality By The Weakest Link," published Feb. 13, 2012). For assets containing early prepayment features, IILM's ability to receive timely payment upon exercise of the early prepayment feature, which in turn provides liquidity support for the certificates, is addressed by our rating on each asset of at least 'A'. As of the date of this report, each of the underlying assets contained an early prepayment feature. For any future assets without an early prepayment feature, our analysis would consider the minimum rating requirement of at least 'A' for the committed investors who are obligated to purchase liquidity certificates.

Further, we review each new seller seeking entry into IILM's program and confirm that the 'A-1 (sf)' rating on the program will not be affected. The credit quality of each asset currently funded by IILM is commensurate with the 'A-1 (sf)' rating on the program. Based on correspondence with the administrator, our understanding is that if an asset were to fall below the minimum rating of 'A', the administrator intends to provide an action plan to mitigate any potential rating effect on the rated certificates, such as through exercising the early prepayment feature. In our view, this would effectively mitigate the risk.

## Performance Update

As of the date of this report, there were eight individual sellers financed by the conduit, with \$3.51 billion in aggregate financing commitments. All of the underlying assets are sukuks rated at least 'A' by S&P Global Ratings. On the liability side, the IILM's certificates are being issued in a variety of tenors not exceeding 364 days, and ranging from one month to seven months tenor.

## Administrator Overview

International Islamic Liquidity Management Corp. is the conduit administrator. It is an international institution established in October 2010 by central banks from key Islamic finance jurisdictions and one multilateral institution. As administrator, it identifies and structures the assets to be funded in the conduit, and arranges the liquidity facilities. We don't typically rely on the credit rating on the program administrator, but we do assess its ability to manage the conduit's daily activities. In our assessment, we focus on four basic areas--or four pillars--of conduit administration: asset origination, asset credit approval, asset-backed commercial paper (ABCP) funding, and surveillance and risk management. During lockdown pertaining to the COVID-19 pandemic, the business continuity plan was successfully activated and enabled the staff to conduct daily operations and ABCP funding remotely and with minimal disruption. Based on our review of the administrator and the ongoing communications, we are satisfied that they are capable of carrying out their responsibilities under the program documents.

## Program Structure

### Certificate issuance

IILM finances each sukuk using the certificates proceeds. The issuance of certificates is subject to certain issuance tests, which ensure that sufficient liquidity is in place to repay the certificates at each maturity date, and that profit amount on the assets is expected to be sufficient to pay senior expenses and the target profit amount on the certificates. In the event the issuance tests are breached, the conduit would still have the ability to issue certificates to the committed investors under the liquidity investment agreement.

### Asset purchases and financing

Under the program's asset eligibility criteria, each asset must be structured in accordance with Sharia principles and have a long-term foreign currency credit rating of at least 'A' when initially purchased. The addition of each new asset is subject to rating agency confirmation.

### Payment priorities

Certificateholders are entitled to receive a profit up to the target profit amount on the maturity date of each series of certificates. The target profit amount will be specified in the new issue terms applicable to each series. Our rating on the certificates addresses the payment of the target profit amount and principal amount on the maturity date of each series, subject to a five-business day grace period, notwithstanding the 14 day grace period on the notes. As

outlined in our rating definitions, our ratings on short-term obligations address a maximum grace period of five business days.

At the program level, available funds are applied in the following order of priority:

- Senior expenses;
- Target profit amount of certificates;
- Principal amount of maturing certificates;
- Subordinated expenses;
- Cash reserve account up to the required amount; and
- Excess to IILM.

## Credit Support

### Programwide credit enhancement (PWCE)

IILM does not benefit from any PWCE. Under our criteria, the minimum amount of PWCE is zero given we consider the conduit to be a small portfolio under our PWCE criteria (see "Related Criteria"). However, since IILM can issue certificates with a tenor of up to 364 days, the conduit is limited to holding 10 assets before a minimum PWCE requirement would apply.

### Cash reserve

There is a cash reserve funded at 2% of the outstanding certificates available to cover any timing mismatch or shortfall between asset cash flows and target profit/maturity amount payable on the certificates. As per the issuance conditions, on any issuance date where the proceeds are used to purchase a new asset, the amount on deposit on the reserve account must be topped up to the required amount.

## Liquidity Support

### Asset-specific liquidity support

The proceeds of new certificates issued will normally be used to repay maturing certificates. If there is a market disruption where IILM is unable to issue new certificates, it will either exercise the early prepayment feature on certain assets in return for the aggregate principal amount plus any accrued profit amount up to the next periodic payment date, or issue certificates to the committed investors with the proceeds used to repay the holders of the maturing certificates.

For assets containing early prepayment features, the sukuk sponsor's repayment obligation upon execution of the early prepayment feature will ensure the IILM certificates will be repaid within five business days of their scheduled maturity date, which is within the stated two-week grace period. The sukuk sponsor's ability to honor their repurchase obligation under the early prepayment feature is reflected in our explicit rating on each sukuk funded by the conduit.

Committed investors provide liquidity support for the certificates issued by IILM to fund the assets that do not have an early prepayment feature. Under these liquidity investment agreements, the committed investors have an obligation to purchase certificates with payment dates that are match funded to those of the underlying assets. However, since all the underlying assets currently benefit from early prepayment features, the commitment under the liquidity investment agreements is nil. That said, under the terms of the agreements, the commitment amount would automatically increase to provide liquidity support for any future assets that do not have an early prepayment feature, subject to the maximum commitment amount. The obligation of committed investors to purchase certificates is not dependent on either the rating on the assets or the rating on the certificates. In addition, the target profit amount on liquidity certificates is capped to mitigate interest rate risk, and certain issuance conditions do not need to be met for the issuance of liquidity certificates.

## Legal Issues

IILM is structured to be bankruptcy remote, thereby mitigating the potential for an insolvency of the program upon an insolvency of the owner, International Islamic Liquidity Management. The structure benefits from an additional feature in the form of a golden share held by a nominee trustee, thereby restricting the ability of IILM to unilaterally change the incorporation documentation of the vehicle to the potential detriment of the certificate holders. Additionally, there are limitations of the transfer of the shares held by IILM to other parties. We received legal opinions at closing evidencing there are no applicable taxes. In our view, the conduit structure is consistent with our legal criteria (see "Related Criteria").

Asset-specific legal risks are reviewed when each new transaction is added to the program. For each underlying asset, we review the mitigants to potential tax risk since the repayment of liquidity certificates issued to the committed investors is ultimately dependent on asset cash flows.

## Counterparty Risk

Our rating on the certificates is weak-linked to the rating of each underlying asset, and for assets without an early repayment feature, also the highest rated committed investor under the joint and several liquidity investment agreement.

The transaction is also exposed to counterparty risk through Citibank Europe PLC as the issuer bank account provider. In our view, the transaction's replacement mechanisms adequately mitigate its exposure to the bank account provider at the assigned rating levels under our current counterparty criteria (see "Related Criteria").

The transaction is also exposed to the custodian through Citibank N.A., Hong Kong branch, which holds the underlying sukuks on trust in a jurisdiction that is typical for these accounts in structured finance transactions, and for the issuer's benefit. We consider that this exposure is fully mitigated as we believe that the securities and cash deposited in a trust or custodial institution would be subject to laws and regulations that isolate this account from the counterparty's insolvency risk.

## Key Performance Indicators

Under the program-level documents, our confirmation that the inclusion of any new seller will not affect the 'A-1 (sf)' rating on IILM is a precondition to the funding of any new seller. Therefore, as part of our continuous surveillance process, we will review the proposed structure of any new seller seeking entry into IILM and confirm accordingly.

We receive regular reports detailing the underlying assets, and continuously monitor the ratings on the support providers, including the committed investors, as liquidity providers. There is also rating dependency on each asset, and any downgrade of an asset or liquidity provider below 'A' would initiate a surveillance review. We also expect the administrator to highlight any new developments in a timely manner.

## Related Criteria

- Criteria - Structured Finance - General: Counterparty Risk Framework Methodology And Assumptions, March 8, 2019
- Incorporating Sovereign Risk In Rating Structured Finance Securities: Methodology And Assumptions, Jan. 30, 2019
- Structured Finance: Asset Isolation And Special-Purpose Entity Methodology, March 29, 2017
- Criteria - Structured Finance - General: Methodology: Criteria For Global Structured Finance Transactions Subject To A Change In Payment Priorities Or Sale Of Collateral Upon A Nonmonetary EOD, March 2, 2015
- Criteria - Structured Finance - ABCP: Global Methodology For Analyzing Liquidity Funding Outs And Limitations In ABCP Transactions, Oct. 27, 2014
- Criteria - Structured Finance - ABCP: Global Methodology And Assumptions For Calculating Programwide Credit Enhancement In Multiseller ABCP Conduits, Feb. 14, 2013
- Criteria - Structured Finance - General: Criteria Methodology Applied To Fees, Expenses, And Indemnifications, July 12, 2012
- General Criteria: Global Investment Criteria For Temporary Investments In Transaction Accounts, May 31, 2012
- Criteria - Structured Finance - ABCP: Asset-Backed Commercial Paper Issued By Multiseller Conduits: Classification And Timing Of Reviews For New-Seller Transactions, April 18, 2011
- Principles Of Credit Ratings, Feb. 16, 2011
- Criteria - Structured Finance - ABCP: Standard & Poor's Analysis Of ABCP Ratings Following Changes To Ratings On Support Providers, Dec. 18, 2008
- Criteria - Structured Finance - ABCP: Global Asset-Backed Commercial Paper Criteria, Sept. 29, 2005

## Related Research

- S&P Global Ratings Definitions, Dec. 7, 2020
- Inside Global ABCP: Issuance Growth Tempered As Economic Recovery Takes Shape, Oct. 8, 2020
- How COVID-19 Is Affecting ABCP, June 12, 2020
- 2017 EMEA ABS SCENARIO AND SENSITIVITY ANALYSIS, July 6, 2017
- Global Structured Finance Scenario And Sensitivity Analysis 2016: The Effects Of The Top Five Macroeconomic Factors, Dec. 16, 2016
- European Structured Finance Scenario And Sensitivity Analysis 2016: The Effects Of The Top Five Macroeconomic Factors, Dec. 16, 2016
- How We Rate And Monitor EMEA Structured Finance Transactions, March 24, 2016
- International Islamic Liquidity Management 2 SA's US\$500 Million Landmark Islamic Finance Program Assigned 'A-1' Rating, April 4, 2013
- Standard & Poor's Clarifies Its Approach To Requests For Rating Agency Confirmation On Global Structured Finance Transactions, May 18, 2012
- Assessing Credit Quality By The Weakest Link, Feb. 13, 2012
- Standard & Poor's Requests Transaction Performance Metrics From Sponsors Or Administrators Of Global Multiseller ABCP Conduits, Jan. 12, 2012
- Liquidity: Why Do Asset-Backed Commercial Paper Conduits Need It And Where Do They Get It?, Sept. 14, 2007
- Standard & Poor's Global Approach To ABCP Conduit Administration, July 7, 2008
- Credit FAQ: Analyzing Payment Waterfalls In ABCP Conduits, July 2, 2008
- How Standard & Poor's Analyzes Interest Rate Risk For Asset-Backed Commercial Paper, July 2, 2008



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

Issuer	Country	Type	Rating as of October 4, 2021
Al Baraka Banking Group B.S.C.	Bahrain	Bank	BB-/Negative/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
Al Khaleej Takaful Group (Q.P.S.C.)	Qatar	Insurance	BBB/Positive/--
Qatar Islamic Bank (Q.P.S.C.)	Qatar	Bank	A-/Stable/A-2
Al Rajhi Bank	Saudi Arabia	Bank	BBB+/Positive/A-2
Islamic Development Bank	Saudi Arabia	Multinational	AAA/Stable/A-1+
The Company for Cooperative Insurance	Saudi Arabia	Insurance	BBB+/Positive/--
Wataniya Insurance Company	Saudi Arabia	Insurance	BBB/Stable/--
Islamic Corporation for Development of the Private Sector	Saudi Arabia	Multinational	A-/Stable/--
Wala Cooperative Insurance Company	Saudi Arabia	Insurance	A-/Stable/--
AlBaraka Turk Katilim Bankasi AS	Turkey	Bank	B/Negative/B
Islamic Arab Insurance Co. (Salama)	UAE	Insurance	BBB/Watch Neg/--
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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