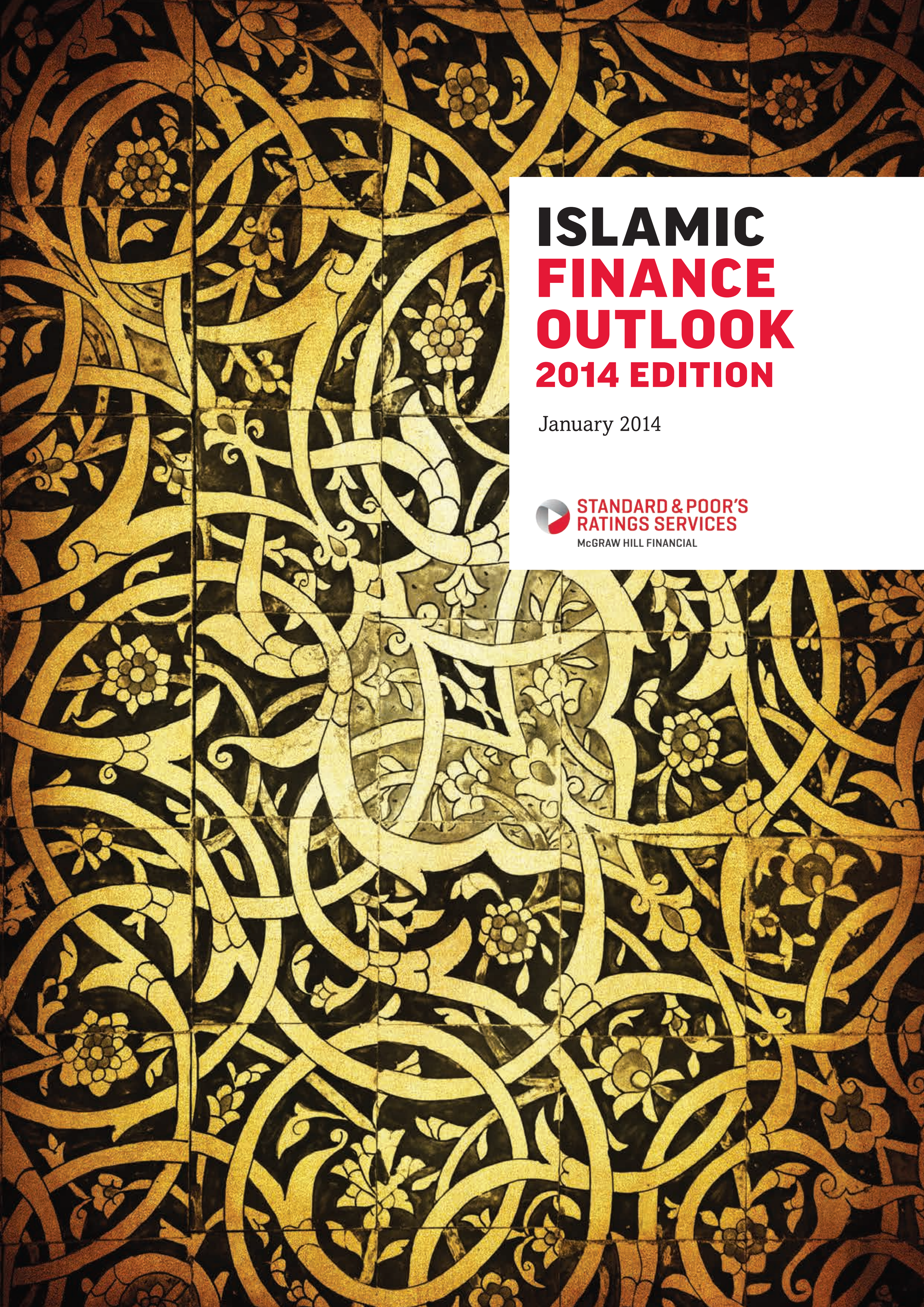

ISLAMIC FINANCE OUTLOOK 2014 EDITION

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STANDARD & POOR'S RATINGS SERVICES
McGRAW HILL FINANCIAL

CONTENTS

FOREWORD *Authors: Zeynep Holmes and Surinder Kathpalia*

Global growth of the Islamic finance market has continued unabated this year, undeterred by the uncertain recovery elsewhere in the world's financial markets. Standard & Poor's Ratings Services believes that worldwide, Sharia-compliant assets--which we estimate at upward of $1.4 trillion--are likely to sustain double-digit growth in the coming two to three years.

Despite more than a decade of heady growth, the industry is still in a formative stage. But we believe it's only a matter of time before it achieves critical mass, as the pool of assets broadens and deepens, and enhances liquidity. Nevertheless, the speed at which the industry matures and joins the mainstream comes down to how market participants address a classic imbalance between supply and demand. Islamic finance remains a demand-driven market, with scarce supply, still hampered by a limited range of Islamic financial centers and their variously regulated environments. In our view, expansion and enhancement of existing centers, and a more transparent regulatory environment could build the momentum for the growth needed to break into the mainstream.

We believe that regulatory efforts to accommodate Islamic finance and the establishment of additional industry bodies at national levels will take center stage starting in 2014. Interestingly, newcomers in the industry—such as Oman, Turkey, and Nigeria, for instance—have started to trace the footsteps of fast-growing pioneers, such as Malaysia. Right behind the newcomers, a long line of countries is aspiring to enter the market, with the continent of Africa in the forefront.

Then, too, the gradual building out of local and regional regulatory frameworks and establishment of standards ought, in our opinion, to minimize the barriers that are preventing the industry from achieving its full potential. Globally accepted standards, we believe, are necessary for growth of the industry. In this respect, we believe that the two regional heavyweights and pioneers of the industry—Asia (most notably Malaysia) and the Gulf Cooperation Council (comprising Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates)—are set to lead the way. Aspiring regional champions—such as Turkey—may also help foster a more systematic approach to channeling and shaping growth in Islamic finance.

For more than a decade, Standard & Poor's has served market participants in Islamic finance with its independent and objective credit opinions. We are honored to be the recipient of several awards in 2013: "Best Rating Agency;" the "International Takaful Award" (for the sixth year in a row); the "Asset Triple A Award" (third consecutive year); and the "Islamic Finance News Award" (second year in a row). Our in-house, global team of dedicated analysts not only monitors the credit quality of the companies and instruments we rate, but also is involved in formulating coherent, transparent rating methodologies, and timely opinions about trends shaping the Islamic finance industry. Up until November 2013, we expanded our ratings coverage of sukuk entities in the GCC, Turkey, and Asia by eight high-profile sukuk, for a total of about $8 billion. We were also the first rating agency to rate the International Islamic Liquidity Management (IILM) vehicle, a groundbreaking structure providing Islamic banks with a viable alternative for managing liquidity.We hope that our position as a leading credit rating agency, and our commitment toward analytical and service excellence will further assist in the maturation of the Islamic finance industry as it strives to enter the mainstream of the world economy. As always, we welcome your feedback on our research and insights.

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التمويل الإسلامي للعام 2014
توقعات بتحقيق نمو مكون من رقم مزدوج وإعطاء دفعة للتنظيم ووضع المعايير

بقلم زينب هولميز وسوريندر كاثباليا

واصل التمويل الإسلامي نموه العالمي المُطَّرد هذا العام، ولم يعرقله الانتعاش غير المؤكد في الأسواق المالية الأخرى في العالم. وتعتقد وكالة "ستاندرد آند بورز لخدمات التصنيف الائتماني"، بأنه من المرجح أن تحافظ الأصول المتوافقة مع الشريعة الإسلامية في أنحاء العالم والتي بلغت نحو 1.4 تريليون دولار أمريكي تقريباً في نهاية العام 2012 بحسب تقديراتنا على نموٍ مكون من رقم مزدوج خلال العامين إلى الثلاثة أعوام المقبلة.

وعلى الرغم من مرور ما يزيد عن عقدٍ من النمو المتواصل، إلا أن القطاع لا يزال في مرحلة تشكُّله. لكننا نعتقد بأن إحراز تقدمٍ كبير هو مسألة وقت فقط، نظراً لتوسّع وتعمّق حجم الأصول، وتعزيز السيولة. ومع ذلك، فإن سرعة نمو القطاع وانضمامه إلى قلب الاقتصاد العالمي جاء نتيجةً للأسلوب الذي اتبعه المشاركون في السوق في معالجة اختلال التوازن التقليدي ما بين العرض والطلب. ويبقى قطاع التمويل الإسلامي سوقاً يحركه الطلب، مع ضعف في العرض، حيث لا يزال يعيقه العدد المحدود للمراكز الإسلامية، وبيئاتها المُنَظمة بطرق مختلفة. ومن وجهة نظرنا، فإن توسيع وتحسين المراكز القائمة حالياً، واعتماد بيئة تنظيمية أكثر شفافية، يُمكِنه بناء الزّخم اللازم للدخول إلى قلب الاقتصاد العالمي.

نعتقد بأن الجهود التنظيمية لاستيعاب التمويل الإسلامي وإقامة المزيد من الهيئات القطاعية على المستويات الوطنية ستتبوأ مركز الصدارة بدءاً من العام 2014. وما يثير الاهتمام هو أن الوافدين الجدد في القطاع مثل عُمان، وتركيا، ونيجيريا على سبيل المثال قد بدأوا بالسير على خطى رواد السوق الذين يحققون نمواً سريعاً، مثل ماليزيا. وعلى درب الوافدين الجدد هناك الكثير من الدول التي تتطلع إلى دخول السوق، حيث تأتي قارّة أفريقيا بمركز الصدارة.

وكذلك، فإن البناء التدريجي للأُطر المحلية والإقليمية ووضع المعايير اللازمة هدفه، من وجهة نظرنا، إزالة العوائق التي تمنع القطاع من إنجاز إمكاناته الكاملة. ونعتقد بأن وضع معايير مقبولة عالمياً ضروري لنمو القطاع. وفي هذا الشأن نتوقع بأنه قد تم تهيئة اثنتين من كبريات الشركات الإقليمية ورواد القطاع آسيا (أبرزها ماليزيا) ودول مجلس التعاون لدول الخليج العربية (المكون من البحرين، والكويت، وعُمان، وقَطر، والمملكة العربية السعودية، والإمارات العربية المتحدة) لقيادة الطريق. وقد تساعد الدول الإقليمية الطموحة مثل تركيا أيضاً على تعزيز نهج يكون أكثر تنظيماً لتحديد مسار وشكل نمو قطاع التمويل الإسلامي.

عملت وكالة "ستاندرد آند بورز" لما يزيد عن عقد من الزمن في خدمة المشاركين في السوق في قطاع التمويل الإسلامي، مقدمةً لهم آرائها الائتمانية المستقلة والموضوعية. وكان لنا شرف الحصول على عدة جوائز إضافية في العام 2013 وهي "أفضل وكالة تصنيف"، و"جائزة التكافل الدولي" (للسنة السادسة على التوالي)، و"جائزة مجلة أسيت تريبل" (للسنة الثالثة على التوالي)، و"جائزة الأخبار المالية الإسلامية" (للسنة الثانية على التوالي). ولا يقتصر عمل فريقنا الداخلي العالمي من المتخصصين على مراقبة جودة الائتمان للشركات والأوراق المالية التي نصنفها، ولكنه يشارك أيضاً في وضع منهجيات التصنيف الموحدة والشفافة. وحتى نوفمبر من العام 2013 قمنا بتوسيع تغطيتنا لتشمل كيانات الصكوك في منطقة دول مجلس التعاون لدول الخليج العربية، وتركيا، وآسيا. كما كنا أول وكالة تصنيف تقوم بتصنيف أداة إدارة السيولة الإسلامية الدولية، والتي تعد هيكلاً رائداً يزوّد البنوك الإسلامية ببديل صالح لإدارة السيولة.

تأمل "ستاندرد آند بورز" بصفتها وكالةً رائدةً في التصنيف الائتماني وملتزمةً بالتميز التحليلي وتقديم الخدمات بأن تقدم المزيد من المساعدة في عملية تطوير قطاع التمويل الإسلامي الذي يسعى لأن يكون في قلب الاقتصاد العالمي. ونحن نرحب دائماً بملاحظاتكم ومقترحاتكم حول أبحاثنا ورؤيتنا.

STANDARD & POOR'S AWARDS

The International Takaful Awards 2013
Best Rating Agency

The Asset Triple A Awards 2013 Islamic Finance
Best Rating Agency for Islamic Finance

Islamic Finance News 2013
Best Islamic Rating Agency

The Asset Triple A Awards 2012 Islamic Finance
Best Rating Agency for Islamic Finance

The International Takaful Awards 2012
Best Rating Agency

Islamic Finance News 2012
Best Islamic Rating Agency

The International Takaful Awards 2011
Best Rating Agency

Intelligent Insurer Awards 2011
Global Best Rating Agency

The Asset Triple A Awards 2011 Islamic Finance
Best Rating Agency for Islamic Finance

Reactions London Market Awards 2011
Best Rating Agency

The International Takaful Awards 2010
Best Rating Agency

The International Takaful Awards 2009
Best Rating Agency

The International Takaful Awards 2008
Best Rating Agency

Islamic Finance News Award 2007
Best Islamic Rating Agency

INVESTOR APPETITE IS PUSHING SUKUK INTO THE MAINSTREAM

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There is little to hinder another strong performance by the sukuk market in 2013, especially as we anticipate yield on bonds will remain low in the coming quarters. Global issuance expanded for the fourth year in a row in 2012, growing 64% to about $138 billion, and we expect another strong few years. Despite the growth spurt, the sukuk market is still a small segment of the global fixed-income world. Largely dominating issuance are sovereign and sovereign-related issuers from Malaysia, and, to a lesser extent, from the countries of the Gulf Cooperation Council (GCC; comprising Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates or UAE). (Watch the related CreditMatters TV segments titled "Growth In Global Sukuk Issuance Set To Continue in 2013," dated March 13, 2013).

And while still considered an alternative investment, Standard & Poor's Ratings Services believes sukuk have the potential to grow and join the mainstream. Funding needs and large infrastructure investments in Malaysia and the GCC, combined with better global investor sentiment, are behind today's momentum in the sukuk market. For that reason we believe that GCC issuers, especially, are likely to come to market with bigger issues that are more commensurate with the potential suggested by their asset size. Yields in the region have been declining, and even fell under those on conventional debt. Add to that strong domestic appetite for Islamic finance and sound liquidity, as well as greater political willingness to move ahead with sizable infrastructure projects. We believe that a number of banks, particularly, will come to market, needing to refinance their existing debt and seeking larger amounts to match the credit needs of their corporate clients, especially in project finance.

OVERVIEW

- New sukuk issuance worldwide could exceed $100 billion again this year, according to our base-case scenario for investment spending and economic growth, supported by tight yields and innovative structures.
- We believe that sovereign and sovereign-related issuance, arising from funding and infrastructure investment needs, will continue to dominate, shape, and underpin the market.
- The Asian and GCC sukuk markets are becoming more interdependent, as the number of cross-border transactions pick up, notably those denominated in Malaysian ringgit.
- Liquidity is gradually improving as large and more frequent issuance comes to market and as sukuk gain greater acceptance as a mainstream debt instrument.

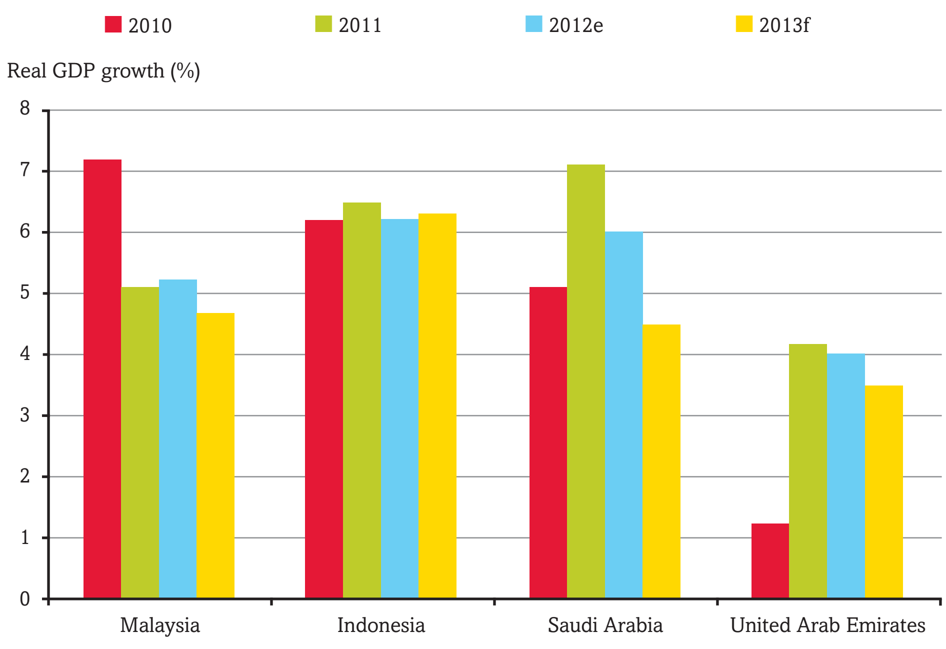
The Malaysian ringgit (MYR) has confirmed its status as a currency of choice for sukuk issuance by non-Malaysian entities. For the first time last year, the amount issued in ringgit worldwide exceeded the amount issued by Malaysian issuers in all currencies. We believe the strength of the Malaysian model for Islamic finance is an alluring proposition for issuers and investors alike, especially in the GCC, further strengthening Asia as a primary force in this segment. In turn, we anticipate that supportive GCC-Asian trade policies and the global search for yield will add to the attraction of GCC sukuk as an investment proposition, most notably to Asian investors.

As the sukuk industry grows and evolves, we remain on the lookout for implications for investors and creditworthiness. We believe that it is only a matter of time before the market develops a sufficient pool of available liquidity.

Large Infrastructure Projects, Particularly In Malaysia And The GCC, Are Likely To Stoke Issuance
We believe that new issuance of sukuk worldwide could top well above $100 billion again this year, according to our base-case scenario for investment spending and economic growth, along with our assumptions about continued high oil prices and low bond yields. In addition, jumbo issuance may pick up further, mainly on the back of huge infrastructure projects from sovereigns. Turkey, Qatar, and Malaysia issued more than $1 billion over the past two years.

Sustained investment spending and ample domestic liquidity are likely to support sukuk issuance, especially in Malaysia, Saudi Arabia, Qatar, and the UAE. Investment spending could see high-single-digit growth for 2013, if it continues at the rates we are seeing in the first quarter. We estimate that the real investment growth rate was 6% in Malaysia and 7.4% in Saudi Arabia in 2012. This contributed to real GDP growth that reached 5.2% in Malaysia, and exceeded 5% in some GCC countries (see chart 1).

CHART 1
REAL GDP GROWTH FOR SELECTED GCC COUNTRIES AND MALAYSIA



e--Estimate. f--Forecast.

The economic slowdown in China and elevated political tensions in the Middle East could be impediments

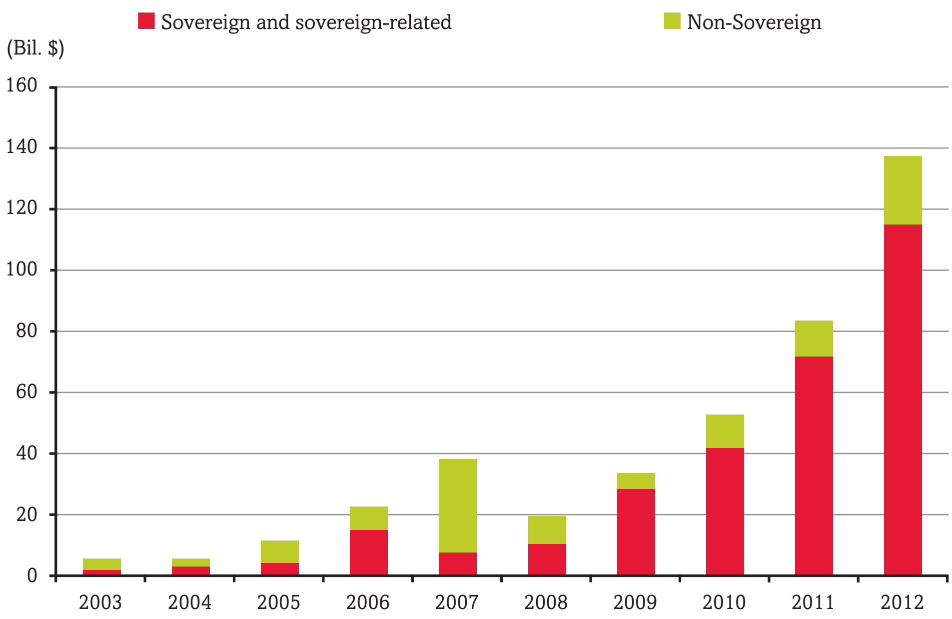
The sukuk market, centered in Malaysia, is not only vulnerable to weaker economic conditions in the Asia-Pacific, especially lower growth in China, but also to the troubles in the eurozone and the feeble U.S. recovery. We lowered our base-case forecasts for real GDP growth for most Asian countries in 2012 and 2013. If Malaysia faces a severe drop in external demand, foreign investment and liquidity could suffer.

In the GCC, a potential recurrence in geopolitical tensions could affect investments in Saudi Arabia and Qatar, two leading issuing countries. For example, political and social unrest in Bahrain, engendered by the Arab Spring, resulted in an almost one-third decline in sukuk issuance in 2012--which investors nevertheless continued to snap up. Less likely, if oil prices were to drop significantly for an extended period, the GCC would feel the effects. The concomitant drop in oil revenues, which account for the overwhelming share of external and fiscal revenues, could lead to a broad-based tightening in liquidity.

Sovereign Issuers Dominate The Sukuk Market

We believe that sovereign and sovereign-related issuance will continue to dominate, shape, and underpin the sukuk market, as it has in the past several years. Sovereign sukuk are generally the first inroad into Sharia-compliant funding in any given country, enabling the gradual creation of reference prices over time, to which private-sector entities can benchmark themselves. From a sovereign perspective, Islamic bonds can give governments access to a new investor class by diversifying sources of fiscal funding. They can also help to cover external financing needs and support reserve building. This is important for countries with sizable fiscal funding needs, such as Malaysia or those in North Africa, but less so for GCC countries, which generally enjoy healthy fiscal and external accounts. Sovereign-related issuance reached a record $115 billion globally in 2012, comprising about 80% of total issuance for the fourth year in a row (see chart 2). The segment also represents about 70% of the sukuk that Standard & Poor's rate.

CHART 2
SOVEREIGN AND NONSOVEREIGN SUKUK AS A SHARE OF TOTAL ISSUANCE

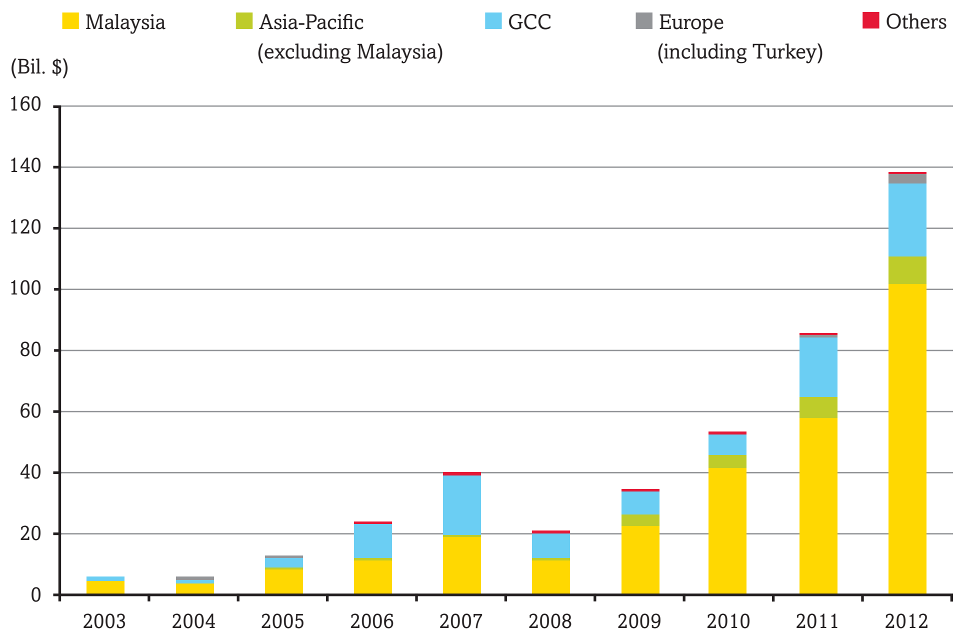


Note: Data shows sukuk issued in a given year, including sukuk that have already matured by year-end.
Sources: Standard & Poor's, Zawya Sukuk Monitor Database.

We see that two bodies are actively and increasingly helping in the development of sovereign sukuk: the Saudi-based Islamic Development Bank (IDB) and the Malaysia-based International Islamic Liquidity Management Corp. (IILM; not rated). The IDB is a multilateral development financing institution, whose stated purpose is to foster economic development and social progress in 56 member countries in accordance with Sharia principles. In that regard, it invests in sovereign sukuk, and issues sukuk with the aim of providing low-cost funds to member countries. The IDB is the only sukuk issuer that we rate ‘AAA’, through, notably, two programs for the finance of infrastructure projects: an $8 billion IDB Trust Services Ltd. global sukuk and a MYR1 billion Tadamun Services Bhd. sukuk geared to the Malaysian market. The IILM, founded in 2010 by central banks, monetary authorities, and multilateral organizations, seeks to play a vital role in developing much-needed short-term Sharia-compliant liquidity solutions for Islamic financial institutions.

We believe that the GCC and Asia will remain the key engines for growth of the sukuk market in the coming 18-24 months. We may see new issuers, most probably sovereigns, though with modestly sized issues to test the waters and investors’ risk appetite. And we may see the debut of issuers outside these two regions, like the Development Bank of Kazakhstan with its MYR1.5 billion sukuk program in 2012. The pace and frequency of issuance in those frontier markets, in our view, will depend greatly on their capacity to develop Islamic finance infrastructure. Further afield, we don’t rule out the possibility that more African sovereigns will enter the market. Some African countries have been growing strongly over the past few years, and most have huge infrastructure investment needs. So far, only two African sovereigns have come to the domestic market with sukuk--Gambia and Sudan--but we understand that a number of them are considering either domestic or global issuance (see chart 3 and “Will African Sovereigns Turn to Islamic Finance to Fund Growth?” published on RatingsDirect on the Global Credit Portal on Feb. 22, 2013).

CHART 3
TOTAL SUKUK ISSUANCE BY MAJOR REGION



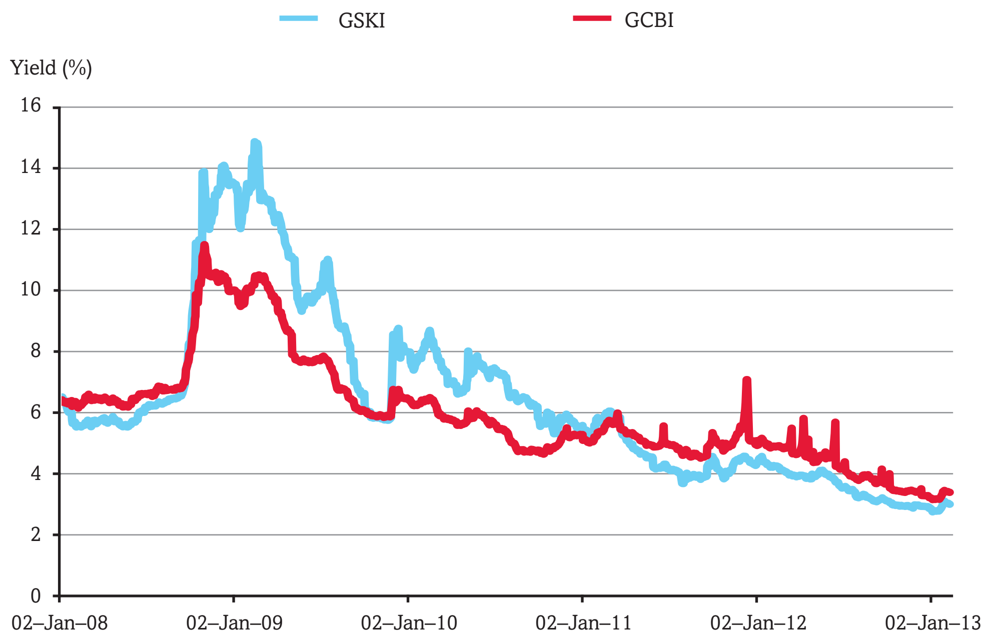
Asia-Pacific (excluding Malaysia)--Indonesia, Pakistan, Brunei, Singapore, Japan, Iran, China. GCC--Gulf Cooperation Council, comprising Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates. Europe (including Turkey)--Germany, U.K., Turkey, France. Others--U.S., Sudan, Gambia, Jordan, Yemen, Kazakhstan. Sources: Standard & Poor’s, Zawya Sukuk Monitor Database.

Tighter Yields Are Drawing Out GCC Issuers

We believe that the rebound in sukuk issuance from the GCC since 2011 is set to intensify, following muted years after the global financial crisis. Total sukuk issuance in the Gulf increased to $24 billion in 2012. We further believe that the region's economic resilience, strong project pipeline, and regional refinancing needs could boost its issuance to match Malaysia's over the long run. Although sovereign or sovereign-related entities are the main issuers, we believe private-sector entities may be able to ride the wave.

Yields on GCC sukuk appear to be consolidating at historic lows (see chart 4). Low interest rates worldwide and investors' preference for the bond markets--over still-depressed equity markets--largely explain the trend. The tight yields also indicate continued strong investor demand for all manner of fixed-income products in the GCC, despite the financial woes in Dubai and political troubles in Bahrain from 2008 to 2011. Although not specific to the GCC, demand is also coming from international investors and sukuk funds in the region.

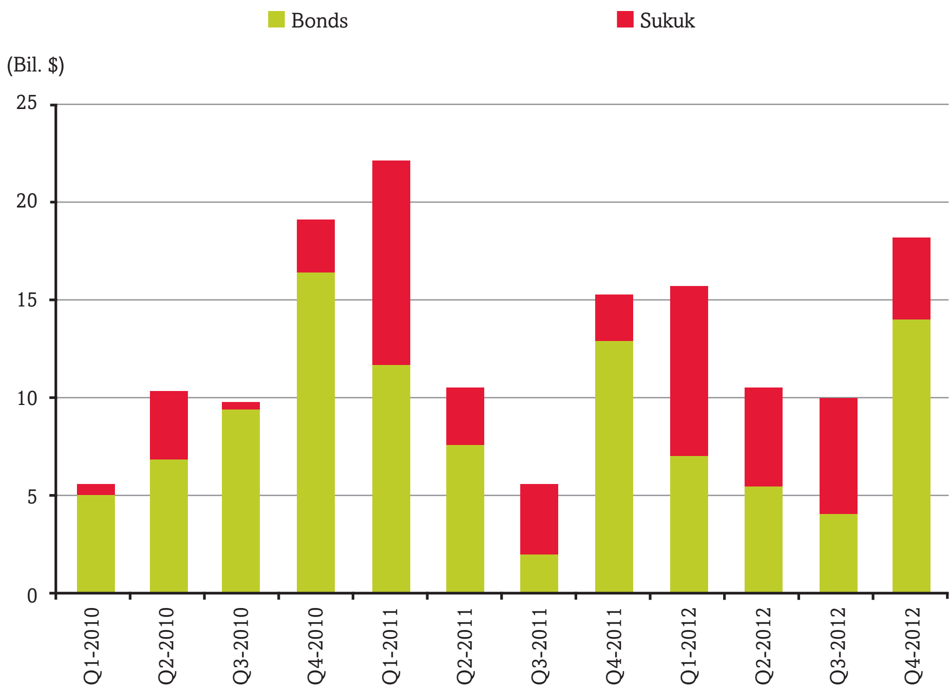
CHART 4
YIELDS ON GCC SUKUK AND CONVENTIONAL BONDS



GSKI--GCC Sukuk Issuers Index. GCBI--GCC Conventional Bonds Issuers Index. Sources: HSBC Nasdaq, Standard & Poor's.

Not only have yields plunged on GCC sukuk, they've turned convincingly lower than yields on conventional bonds. As a result, the debt market may continue to see more sukuk than conventional fixed-income issuance, as it did for the first time in 2012 (see chart 5). The tide started to turn about two years ago, when political concerns started to recede and highly creditworthy bodies like the Qatar Central Bank went to the market. These events reset the pricing curve to echo renewed investor confidence. Other factors contributing to the low sukuk yields, we believe, are realistic pricing and by now confirmed investor acceptance of longer tenors of five years and more--after their first tests of the market in 2006 and 2007. As a result, we believe GCC sovereigns, government-related entities (GREs), and banks, especially, will take advantage of these favorable market conditions to issue sukuk in the next few years.

CHART 5
GCC SUKUK AND BOND ISSUANCES



Sources: Zawya Sukuk Monitor Database, Standard & Poor's, S&P Capital IQ.

We believe that GCC banks that are sukuk issuers--those in Saudi Arabia, Qatar, and the UAE--will increasingly turn to the market for funding sources, and perhaps in more innovative ways, not only because of the attractive market conditions but also to meet funding needs and increasingly stiff regulatory capital requirements. For example, in November 2012, Abu Dhabi Islamic Bank (not rated) issued a $1 billion perpetual sukuk to strengthen its regulatory capital ratios. The sukuk qualified as a Tier 1 instrument because the issue was deeply subordinated and senior only to ordinary shares. Investors snapped up the notes at 6.375%--compared with an initial float price of about 7%. Gulf banks issued $7.2 billion of sukuk in 2012, of which $4 billion was issued by banks that we rate, up 55% from 2011.

Banks in Saudi Arabia and Qatar are set to increasingly issue debt in 2013 and 2014, including sukuk, because of strong growth in lending that is outstripping deposit taking. In the UAE, where credit growth is stagnant, banks may continue to tap the debt markets to issue long-tenor paper to improve their long-term funding profiles.

We believe the project finance sector will increasingly rely on sukuk to fund transactions, taking advantage of the good market conditions. Infrastructure-related sukuk, especially for transportation projects, increased to $6 billion in 2012 after two years of barely any issuance. Transportation represented 67% of all GCC issuance within the infrastructure segment in 2012.

We further believe that countries in the region, especially Saudi Arabia, will continue to favor issuing through their GREs rather than through the sovereign. For example, the Kingdom's General Authority for Civil Aviation (not rated) issued Saudi Arabian riyal (SAR) 15 billion (about $4.1 billion) to help fund the expansion of the Jeddah airport, and Saudi Aramco Total Refining Petrochemical Co. issued $1 billion of sukuk to finance the development of the Jubail refinery. Dubai's GREs as well have a number of sukuk transactions in the pipeline, though not to the exclusion of the recent sovereign 10-year $750 million sukuk that the Dubai Department of Finance issued in January 2013, which was largely oversubscribed and priced at an attractive 3.875%.

Another example is the $1 billion sukuk with a five-year tenor that Dubai Electricity and Water Authority (DEWA) issued in March 2013, which we view as significant for two reasons:

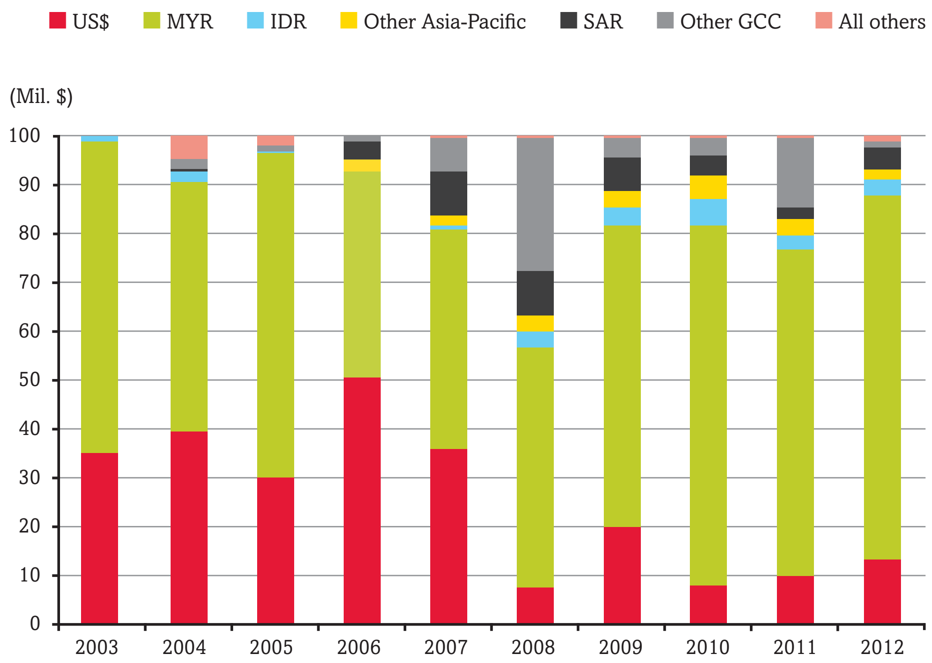
- It is the first foray by DEWA into U.S. dollar-denominated sukuk, and
- The yield on this asset-based sukuk is much lower, at a profit margin of 3% compared with the close to 6% yield on DEWA's bond issuances of similar tenor two years ago.

We understand that this issuance attracted a mixture of international and regional investors. The pricing reflects the appetite for investment-grade quality infrastructure issuance in the GCC. The transaction may set a benchmark for other strong credit quality GRE credits in the region.

The Malaysian Ringgit Is Becoming A Currency Of Choice For Sukuk Issuance

The Asian and GCC sukuk markets are becoming more interdependent as the number of cross-border transactions between the regions pick up, and because of increasing use of the Malaysian ringgit as preferred currency of choice (charts 6). Both regions have relatively strong economies and are seeking huge amounts of capital to fund new infrastructure, support economic development, and entice more private-sector investment.

CHART 6
SUKUK ISSUANCE BY CURRENCY



Sources: Zawya Sukuk Monitor Database, Standard & Poor's, S&P Capital IQ.

We believe that cross-border issuance will continue to gather steam, with Malaysia as the main benefactor, as in the past few years. By cross-border issuance, we mean that an entity based in one country chooses to issue and market sukuk in another country, and in all likelihood in that country's currency. For instance, GCC-based entities have been crossing the figurative border with ringgit-denominated issues over the past few years, beginning with pioneering entities such as Abu Dhabi National Energy Co. PJSC, Bahrain-based Gulf Investment Corp., and National Bank of Abu Dhabi. Even though the amounts remain low, ringgit-denominated sukuk issuance in the GCC has been steadily increasing, to $571 million in 2012 from $323 million in 2010. More generally, last year's non-Malaysian entities, such as China-based Noble Group Ltd. and the Development Bank of Kazakhstan, issued upward of $1.5 billion.

The ringgit is becoming a growing, credible alternative to the U.S. dollar for non-Malaysian issuers. Interestingly, issuance in the Malaysian currency by all issuers--domestic and foreign combined--actually exceeded those by Malaysian entities for the first time in 2012. The U.S. traditionally was the only alternative for issuers wanting to appeal to international investors, especially in countries where local currencies are pegged to the dollar such as the GCC countries, with shallow pools of domestic liquidity such as Indonesia, or with a short track record of sukuk issuance--such as Turkey when it first tapped the market in a big way in 2011 and 2012.

We believe that ringgit-denominated issuance will continue to perform strongly, benefitting from, among other factors, Malaysia's well-defined regulations and developed capital markets (both conventional and Islamic), large and diversified pool of investors, standardized sukuk structures with available liquidity, as well as its status as a potential gateway to other fast-growing Asian economies such as Indonesia and China.

Liquidity Is Picking Up, Helping Better Price Formation

Future global growth of the sukuk market, in our opinion, depends directly on greater liquidity and better price formation. Liquidity is tight because the market is still small and viewed as an alternative asset class. This situation is improving as larger and more frequent issues come to market, and as sukuk gain greater acceptance as a mainstream debt instrument.

We note the increasing number of sukuk that are being rated and listed on international stock exchanges, with healthy competition by exchanges to attract issuers. However, most sukuk issued globally are not listed and remain over-the-counter instruments, and rated ones are the exception rather than the rule--although the absolute number of issuers seeking ratings is on the rise. We note that DEWA has listed its $1 billion sukuk on the Nasdaq Dubai market, which bodes well for the emirate's ambitions to become a global hub for sukuk. Listing sukuk on organized markets and rating them not only bolsters liquidity, but also makes it easier for institutional investors to assess and manage these assets. Liquidity has so far grown slowly, partly because it is building in fragmented domestic pools. Malaysia's success is partly explained by the existence of a well-functioning and credible debt capital market, which remains shallower in the GCC.

Price formation has often proved difficult, even for listed sukuk, because some of them trade infrequently. When trade is thin in a market, there are few prices and perhaps even no benchmarks, that is, weak price formation. We believe that sovereign issuance is critical for establishing benchmarks and facilitating price formation for private issuance.

Since its infancy in the 1990s, the sukuk market has experienced exponential growth, that is, until the financial crisis of 2008, which dampened investor appetite globally and across the board. Growth thereafter resumed when confidence returned, largely on the back of comparatively brighter economic prospects in emerging markets. As we look toward the future, Standard & Poor's believes the ability of the Islamic financial industry to overcome questions related to Sharia interpretation, standardization of sukuk structures, and creditworthiness, plays directly into the globalization of the sukuk market and its wider acceptance by international investors.

KUWAIT FINANCE HOUSE

Published: August 20, 2013

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SACP	bb	+	Support	+4	+	Additional Factors	+1

SACP		
Anchor	bbb-	
Business Position	Adequate	0
Capital and Earnings	Adequate	0
Risk Position	Weak	-2
Funding	Average	0
Liquidity	Adequate	

Support	
GRE Support	0
Group Support	0
Sovereign Support	+4

Issuer Credit Rating
A-/Negative/A-2

Major Rating Factors

STRENGTHS

- Geographically diverse lending book.
- Healthy funding base with strong deposit franchise and healthy liquidity profile.
- Strong market position and franchise in Kuwait.

WEAKNESSES

- Large real estate exposure in terms of lending and direct investments.
- High levels of nonperforming loans, which put pressure on financial performance.
- Dependence on capital gains, reducing predictablility of earnings.

OUTLOOK: NEGATIVE

Standard & Poor's Ratings Services' outlook on Kuwait-based Kuwait Finance House (KFH) is negative. This reflects our view that despite a more conservative stance on capital retention and a recent capital increase, KFH's capitalization remains under pressure as a result of its expanding balance sheet and limited earnings generation. We expect the bank's risk-adjusted capital (RAC) ratio before adjustments to exceed 7.0% in the next 18-24 months. However, if this does not occur, for example because of more rapid balance sheet growth than we currently anticipate, we would lower the ratings.

The rating currently incorporates one notch of short-term support. We could remove this from our assessment (thereby triggering a one-notch downgrade) if KFH fails to reduce its reliance on investment income, the bank's overall risk controls were unable to adequately cover its complexity, or the credit underwriting process failed to prevent large swings in asset quality.

A revision of the outlook to stable would require significant improvements in the bank's risk profile. This could result from a reduction of nonbank assets or a stronger risk management framework.

Rationale

The starting point for assigning our ratings on KFH is its 'bbb-' anchor, and our view of the bank's "adequate" business position, "adequate" capital and earnings, "weak" risk position, "average" funding, and "adequate" liquidity, as our criteria define these terms.

We assess KFH's stand-alone credit profile (SACP) at 'bb'. The long-term rating is five notches above the SACP. We assess KFH has having "high" systemic importance in Kuwait. This assessment is supported by the bank's status as the second-largest bank in the country. In addition, we are of the view that the Kuwaiti authorities are "highly supportive" of the country's banking sector. As a result, the long-term rating on the bank benefits from three notches of uplift above the SACP for potential extraordinary government support, if needed. We factor an additional notch into the ratings in recognition of the government's significant ownership stake, as well as economic trends that are strengthening KFH's creditworthiness.

Finally, the ratings incorporate one notch of flexibility adjustment to reflect our expectation that ongoing management initiatives, including asset disposals, will reduce the risk on the bank's balance sheet.

Anchor: 'bbb-'

Under our bank criteria, we use our Banking Industry Country Risk Assessment (BICRA) economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. The 'bbb-' anchor for KFH is based on our industry risk score of '5' for Kuwait (on a scale of 1-10, 1 being the lowest risk), where the bank is registered and regulated, and a blended economic risk score of close to '5'. The blended economic risk score is higher than Kuwait's economic risk score of '4' as some of the countries where the bank operates exhibit higher economic risk scores, such as '6' for Turkey and Bahrain.

For Kuwait, where about 55% of the bank's lending exposure is located, the BICRA score is affected by our evaluation of economic risk, which in our view is shaped by Kuwait's high level of national wealth, sustained and consistent trade surpluses, and a strong and growing net international asset base, which reduces the country's susceptibility to external shocks. However, high concentration in loan portfolios, and high concentration in real estate and construction constrain banks' credit profiles. In terms of industry risk, we believe that the industry has largely stabilized and banks have adequate pricing ability without significant market distortions. In addition, funding conditions are favorable. However, despite recent improvements, we view Kuwait's overall institutional framework as a weakness.

TABLE 1: KUWAIT FINANCE HOUSE KEY FIGURES

	Year-ended December 31				
(Mil. KWD)	**2012**	**2011**	**2010**	**2009**	**2008**
Adjusted assets	14,497.3	13,413.5	12,504.3	11,235.9	10,544.1
Customer loans (gross)	8,775.5	7,845.0	7,360.0	6,780.6	6,288.4
Adjusted common equity	1,351.6	1,396.3	1,519.4	1,461.8	1,505.2
Operating revenues	503.2	431.7	404.0	402.4	482.1
Noninterest expenses	340.9	318.9	277.9	271.8	198.6

Business position: Strong market position in Kuwait and geographically diverse presence

We regard KFH's business position as "adequate." KFH is the second-largest bank in Kuwait, with total assets of $52.3 billion as of Dec. 31, 2012. The bank is 48.8% owned by the Kuwaiti government and public institutions, of which the Kuwait Investment Authority is the main shareholder with a 24.1% stake. It is also listed on the Kuwait Stock Exchange.

KFH has a geographically diverse revenue base thanks to subsidiaries in Bahrain, Turkey, and Malaysia.

Its Kuwaiti operations contributed only 52% of operating revenues in 2012, followed by Turkey, which accounted for 28%.

The bank's business model is reliant on real estate related revenues and market-dependent income, which affects the overall stability and predictability of earnings, in our view. Outside its banking business, KFH has various associates engaged in non-banking businesses and a large portfolio of real estate direct investments dispersed globally. Although the bank has recently achieved visible improvements in its information systems and risk management and there are ongoing efforts to further streamline operations, we view the existing platform and tools as a weakness in terms of the bank's internal requirement of managing these investments and operations globally.

TABLE 2: KUWAIT FINANCE HOUSE BUSINESS POSITION

	Year-ended December 31				
	2012	2011	2010	2009	2008
Total revenues from business line (Mil. KWD)	652.4	558.7	499.5	466.7	541.0
Return on equity (%)	7.1	6.5	8.6	9.7	12.3

KWD--Kuwaiti dinar

Capital and earnings: RAC before adjustments likely to rise above 7% in line with management's capital optimization plan over the next year

We regard KFH's capital and earnings as "adequate." KFH's regulatory capital adequacy ratio was 13.9% and its Tier 1 ratio 13.6% at the end of 2012. The RAC ratio before adjustments, based on the bank's 2012 financial statements, was an estimated 5.4% at year-end. However, the bank completed a 20% rights offer in June 2013 and generated cash proceeds of Kuwaiti dinar 319.5 million (about $1.14 billion), boosting the ratio to 6.7%. We expect the bank's earnings generation and capital retention to improve gradually over the next two years. Consequently, we expect the RAC ratio before adjustments to rise above 7% and remain above that level over the next 18–24 months. Our specific assumptions about the bank's financial performance are as follows:

- Assets and lending growth of about 10%, accompanied by total revenue growth (including revenues from asset sales) that is above balance sheet growth.
- Relative stabilization in asset quality, resulting in slightly lower credit losses over the outlook period, which should help earnings growth. We expect the bank to register earnings growth of above 10% in 2013.
- A limited dividend payout, which should allow the bank to retain an important portion of its earnings.

TABLE 3: KUWAIT FINANCE HOUSE CAPITAL AND EARNINGS

	Year-ended December 31				
(%)	2012	2011	2010	2009	2008
Tier 1 capital ratio	13.6	13.5	14.2	15.1	21.7
S&P RAC ratio before diversification	5.4	6.2	7.3	6.4	N.M.
S&P RAC ratio after diversification	5.0	6.0	7.0	6.1	N.M.
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0
Net interest income/operating revenues	68.2	73.5	76.7	69.9	54.6
Fee income/operating revenues	14.4	13.0	16.1	15.8	14.5
Noninterest expenses/operating revenues	67.8	73.9	68.8	67.5	41.2
Preprovision operating income/average assets	1.2	0.9	1.1	1.2	2.9

N.M.--Not meaningful.

TABLE 4: KUWAIT FINANCE HOUSE RISK-ADJUSTED CAPITAL FRAMEWORK DATA

(KWD 000s)	Exposure*	Basel II RWA	Average Basel II RW(%)	S&P's RWA	Average S&P's RW(%)
Credit risk					
Government and central banks	1,862,709	177,720	10	117,327	6
Institutions	1,273,949	520,300	41	443,639	35
Corporate	5,952,801	6,982,460	117	6,916,661	116
Retail	2,404,527	2,088,750	87	1,468,493	61
Of which mortgage	1,271,675	0	0	511,394	40
Securitization§	0	0	0	0	0
Other assets	972,740	1,499,300	154	1,326,047	136
Total credit risk	12,466,726	11,268,530	90	10,272,167	82
Market risk					
Equity in the banking book†	1,227,174	0	0	11,840,493	965
Trading book market risk	--	1,007,150	--	1,888,406	--
Total market risk	--	1,007,150	--	13,728,899	--
Insurance risk					
Total insurance risk	--	--	--	0	--
Operational risk					
Total operational risk	--	0	--	943,470	--

(KWD 000s)	Basel II RWA	Standard & Poor's RWA	% of Standard & Poor's RWA
Diversification adjustments			
RWA before diversification	12,275,680	24,944,535	100
Total Diversification/ Concentration Adjustments	--	1,959,682	8
RWA after diversification	12,275,680	26,904,217	108

(KWD 000s)	Tier 1 capital	Tier 1 ratio (%)	Total adjusted capital	S&P's RAC ratio (%)
Capital ratio				
Capital ratio before adjustments	1,503,852	13.6	1,351,557	5.4
Capital ratio after adjustments‡	1,503,852	13.6	1,351,557	5.0

*Exposure at default. §Securitization Exposure includes the securitzsation tranches deducted from capital in the regulatory framework. †Exposure and Standard & Poor's risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions. ‡Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. KWD--Kuwaiti dinar. Sources: Company data as of Dec. 31, 2012, Standard & Poor's.

Risk position: Asset quality remains a challenge, resulting in high loan-loss provision charges

We assess KFH's risk position as "weak". Between 2008 and 2012, KFH incurred close to $2.7 billion in credit losses on the back of a rapid deterioration in its asset quality. In addition to problem loans in Kuwait linked to exposure to certain investment companies and the real estate sector, the bank has in the past few years incurred significant losses in its Malaysian lending book. Nonperforming loans (NPLs) from its Malaysian operations constituted about 16% of the bank's reported NPLs as of Dec. 31, 2012, whereas the Malaysian lending book represented less than 8% of total loans. Nevertheless, the bank has cleaned up its Malaysian lending book and we expect lower credit losses from these operations.

KFH's NPLs stood at 7.1% of total loans at year-end 2012, down from 8.8% a year earlier, but this was largely on the back of write offs during the year, rather than recoveries. Loan loss coverage in the same period was 75%.

The bank's single-name lending concentration is limited in the wider context of the Gulf region. KFH's 20 largest nonbank credit exposures represented only 71% of the bank's total adjusted capital on Dec. 31, 2012. However, concentration by economic sector is a major source of risk. Lending to real estate and construction traditionally represents more than 30% of the bank's gross loans. Additionally, the bank has a large portfolio of direct real estate investments and the total balance sheet exposure to the sector remains higher than that of a pure commercial bank. Like other Kuwaiti banks, KFH has large exposure to domestic investment companies. Its 20 largest exposures to domestic investment companies represented about 5% of the lending book or about 35% of the bank's total equity as of year-end 2012. Nevertheless, most exposures have now been restructured, and the bank is not underwriting new loans in this particular sector.

TABLE 5: KUWAIT FINANCE HOUSE RISK POSITION

	Year-ended December 31				
(%)	**2012**	**2011**	**2010**	**2009**	**2008**
Growth in customer loans	11.9	6.6	8.5	7.8	23.6
Total managed assets/adjusted common equity (x)	10.9	9.6	8.3	7.7	7.0
New loan loss provisions/average customer loans	2.2	2.3	2.0	1.6	2.9
Gross nonperforming assets/customer loans + other real estate owned	7.2	8.8	11.8	9.5	10.2
Loan loss reserves/gross nonperforming assets	74.7	81.0	62.1	62.6	50.9

N.M.--Not meaningful.

Funding and liquidity: Average funding and adequate liquidity

We consider KFH's funding to be "average" and its liquidity "adequate." Like other banks based in Kuwait, the bank operates with a low loan-to-deposit ratio, which stood at 88.4% at the end of 2012. The bank funds itself entirely through customer deposits and, given its shareholding structure, enjoys good access to deposits from Kuwaiti government and public sector entities.

The bank maintains an adequate level of liquid assets on its balance sheet, in our view. Broad liquid assets to short-term funding stood at 1.2x at year-end 2012, whereas net broad liquid assets to short-term customer deposits stood at 6.6x at the same date.

TABLE 6: KUWAIT FINANCE HOUSE FUNDING AND LIQUIDITY

	Year-ended December 31				
(%)	**2012**	**2011**	**2010**	**2009**	**2008**
Core deposits/funding base	80.6	83.0	77.6	83.3	80.6
Customer loans (net)/customer deposits	88.4	82.0	89.1	87.8	90.2
Long term funding ratio	85.1	89.0	83.8	86.8	87.6
Broad liquid assets/short-term wholesale funding (x)	1.2	1.9	1.3	1.5	1.6
Net broad liquid assets/short-term customer deposits	6.6	20.4	13.8	15.0	24.7
Net short-term interbank funding/total wholesale funding	17.2	(23.9)	0.4	(6.9)	(17.2)
Short-term wholesale funding/total wholesale funding	86.3	73.2	83.3	91.6	76.0

External support: "High" systemic importance in a "highly supportive" country

We add three notches of support to KFH's SACP to reflect our view that there is a "high" likelihood that the Kuwaiti government would provide extraordinary support to the bank if needed. We consider KFH to be of "high" systemic importance in Kuwait and the Kuwaiti authorities to be "highly supportive" toward the country's banking sector.

Additional rating factors:

We factor an additional notch into our ratings in recognition of the government's significant ownership stake in KFH, as well as economic trends that are strengthening KFH's creditworthiness. In addition, our ratings on KFH incorporate one notch of flexibility adjustment to reflect our expectation that ongoing management initiatives, including asset disposals, will reduce risk on the bank's balance sheet.

QATAR'S ISLAMIC BANKS ARE ON A FAST TRACK TO GROWTH

Published: September 16, 2013

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The government of Qatar intends to make the country a center for Islamic banking, and so far, its strategy is succeeding. Qatar now has one of the fastest-growing Islamic banking sectors in the world, thanks to a surge in the demand for local credit to finance government infrastructure and investment projects. We believe that this demand will endure, and therefore that the assets of Qatar's Islamic banks will continue to grow, and their share of the country's banking system will continue to rise. However, we question the sustainability of growth over the long run once the infrastructure projects slow down, particularly because Qatar has a very small bankable population. This could eventually lead the sector to expand overseas. (Watch the related CreditMatters TV segment titled "Gulf Islamic Banks Continue To Grow Faster Than Their Conventional Peers, But Returns Are Converging With Conventional Banks," dated Oct. 7, 2013.)

OVERVIEW

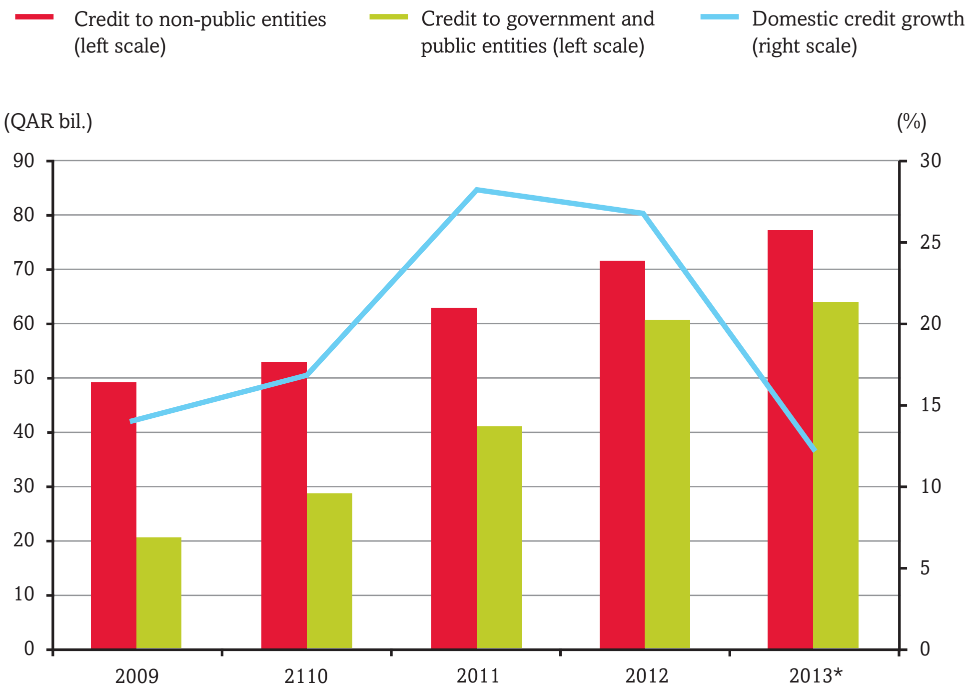
- TWe foresee Qatar's Islamic banks continuing to grow quickly over the next five years, reaching over $100 billion on the balance sheet by 2017, up from $54 billion at year-end 2012.
- The fast pace of growth is thanks to strong support from the Qatari government and increasing demand for domestic credit owing to a large number of infrastructure projects.
- However, we question whether the Islamic banks can sustain this rapid growth over the long term, due to Qatar's very small bankable population. We believe this may eventually lead the Islamic banks to look at overseas expansion.
- Qatari Islamic banks have not traditionally been active in the debt capital markets, but we foresee this changing because of funding and liquidity requirements under Basel III regulations.

Like other countries in the Gulf region, Qatar's debt capital markets are at a nascent stage and the bulk of its credit generation derives from bank lending. It is therefore on account of the Qatari government's large infrastructure and investment projects that the country's domestic credit grew at a compound average rate of 30.9% between 2006 and 2012 (see chart 1 overleaf).

Although we observed a visible slowdown in lending in the first half of 2013 due to administrative delays with certain projects, we expect credit growth to reaccelerate in 2014, when major infrastructure projects start in preparation for Qatar hosting the 2022 World Cup. We believe this will bolster the domestic demand for credit in the country and support the lending activities of Islamic banks.

The total balance sheet of Qatar's Islamic banks was $54 billion as of year-end 2012. Assuming that the banks grow by an average of 15% over the next five years--which is significantly lower than the previous five-year average of 35%--we could see the Islamic banks' asset base exceeding $100 billion by 2017. This could place Qatar's Islamic banking market as the third-largest in the Gulf region, after Saudi Arabia and the United Arab Emirates.

CHART 1
CREDIT GROWTH IN QATAR 2009-2013



*Based on July 2013 annualized figures. Source: Qatar Central Bank Statistical Bulletin.

Qatar's Islamic Banks Are Growing Faster Than Conventional Banks Thanks To Government Backing

The Qatari government's strategy to grow Qatar as an Islamic banking center means that it is highly supportive of this sector. As an Islamic country Qatar is committed to the principles of Sharia. Islamic banks currently represent one-quarter of Qatar's banking system in terms of assets, up from 13% in 2006, and we anticipate that they will continue to gain market share.

For example, in 2011, Qatar Central Bank (QCB) banned conventional banks from extending Islamic banking products through what are called "Islamic windows" in the onshore conventional banking system, thereby requiring conventional banks to close or divest their sharia-compliant businesses and not underwrite any new sharia-compliant loans. As a result, Sharia-compliant banking shifted to the Islamic banks.

Furthermore, the Qatari government and its related entities are the main sponsors of the country's four incumbent Islamic banks. The Qatar Investment Authority (QIA), the nation's sovereign wealth fund, is a key shareholder in three of the Qatari Islamic banks--Masraf Al Rayan, Qatar Islamic Bank, and Qatar International Islamic Bank. In addition, two government-controlled entities--Qatar Holding and Barwa Real Estate--are the principal shareholders of Barwa Bank, the nation's youngest Islamic bank that started operating in 2010.

The key driver of growth in domestic credit in Qatar is government-funded infrastructure and investment projects. We understand that the government ensures that at least a portion of a large project is structured in compliance with sharia law to enable the Islamic banks to participate. Furthermore, in 2012, the Qatari government embarked on a treasury bill issuance program to help the country's local conventional and Islamic banks to manage their liquidity. Some of the issuances under this program are structured in the form of sukuks for the country's Islamic banks.

As a result of the government's supportive actions, the Islamic banking sector in Qatar has grown more quickly than the banking sector as a whole over the past few years. In 2006, the QCB began to report key balance sheet metrics for each of the Islamic banks. These figures show that between 2006 and 2012, Qatar's Islamic banks grew their domestic loans and resident deposits by an average compound growth rate of 46% and 40%, respectively, versus 31% and 23% for the entire banking system (see table 1). Consequently, the Qatari Islamic banks' market share in domestic credit increased from 13% in 2006, to 25% at the end of 2012, while the share in resident deposits increased from 13% to 28% in the same period.

TABLE 1: GROWTH TREND OF QATAR'S BANKING SYSTEM AND ITS ISLAMIC BANKS 2006-2012

(Bil. $)	2006	2007	2008	2009	2010	2011	2012	Period CAGR
Domestic credit	26	40	61	69	81	104	131	30.9%
Islamic banks	3	6	11	14	19	24	32	46.0%
% of Islamic banks	13%	16%	18%	21%	24%	23%	25%	N/A
Total assets	52	81	111	129	157	192	225	27.6%
Islamic banks	8	12	18	24	33	44	54	37.3%
% of Islamic banks	15%	15%	17%	18%	21%	23%	24%	N/A
Resident deposits	33	45	54	62	76	94	115	23.2%
Islamic banks	4	6	9	11	18	24	32	39.9%
% of Islamic banks	13%	14%	17%	17%	22%	25%	28%	N/A

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

The growth of Qatar's Islamic banks has had repercussions for the country's conventional banks. Most conventional banks except Qatar National Bank lost market share to the Islamic players over the past few years, thanks to Qatar National Bank's key role in financing government infrastructure and investment projects. At the same time, the other large conventional banks have faced significant competition from the Islamic banks, particularly in the area of retail lending.

Qatar's Islamic Banks Are Relatively Young, But Have Sizable Assets

There are currently four Islamic banks in Qatar, with a combined asset base of $54.4 billion as of end-June 2013 (see table 2). Although there is discussion in the market about the potential launch of a new Islamic bank with a largely overseas mandate, we have not seen any tangible progress on this to date.

TABLE 2: KEY FINANCIALS OF ISLAMIC BANKS FIRST-HALF 2013

(Bil. $)	Loans	Deposits	Equity base	Total assets	Revenues	Net income
Qatar Islamic Bank	11.4	12.7	3.1	20.3	0.4	0.2
Masraf Al Rayan	12.1	12.8	2.7	17.7	0.4	0.2
Qatar International Islamic Bank	4.6	5.9	1.3	8.6	0.2	0.1
Barwa Bank*	4.4	4.9	1.5	7.8	0.1	0.0
Total	32.5	36.2	8.6	54.4	1.1	0.5

Source: The banks' financial statements. *For Barwa Bank, the figures are as of the first quarter of 2013.

Qatar Islamic Bank (S.A.Q) (A-/Stable/A-2)
Established in 1982, Qatar Islamic Bank is the oldest Islamic bank in Qatar and the largest in terms of assets. It has a balance sheet of $20.3 billion on June 30, 2013. QIA, the country's sovereign wealth fund, currently holds 16.7% of the bank's capital. Individuals, including members of the Qatari royal family, hold about 50% of the shares, and the bank's shares are listed on the Qatar Stock Exchange. Qatar Islamic Bank is predominantly a corporate bank, with retail lending limited to about 16% of the bank's lending book. Among its other activities, Qatar Islamic Bank is highly active in real estate lending and contracting, which together constitute about 36% of its gross lending book as of year-end 2012.

Masraf Al Rayan (not rated)
Established in 2006, Masraf Al Rayan is the Qatari government's main Islamic bank, lending about 63% of total funds to government and public sector entities at year-end 2012. Masraf Al Rayan's lending relationship with the government enabled the bank to report 55% compound annual growth in lending between 2007 and 2012, which was well above the average sector growth rate. Consequently, the bank is now the second-largest Qatari Islamic bank in terms of its asset base ($17.7 billion as of the first half of 2013), and the largest in terms of its lending book of $12.1 billion. As per publicly available data, QIA and the Qatar Armed forces are the largest shareholders in Masraf Al Rayan.

Qatar International Islamic Bank (not rated)
Established in 1991, Qatar International Islamic Bank is the third-largest Islamic bank in the country, with total assets of $8.6 billion and lending of $4.6 billion as of the first half of 2013. Like the other Islamic banks, Qatar International Islamic is largely a corporate bank, with real estate and service sectors constituting 26% and 27% of its gross lending, respectively, at year-end 2012. QIA is one of the key shareholders of the bank.

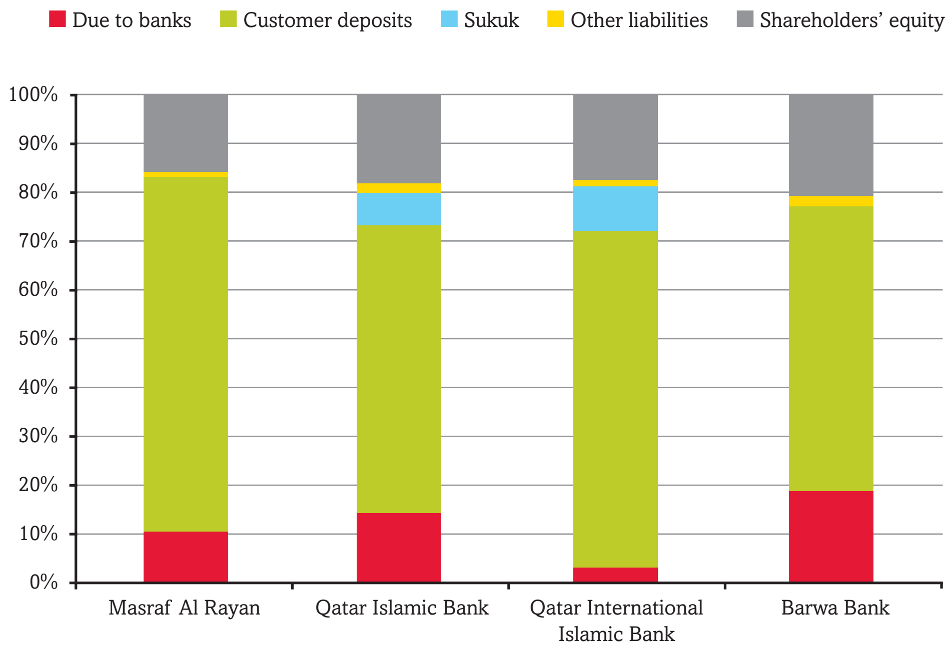
Barwa Bank (not rated)
Barwa Bank is the youngest Islamic Bank in Qatar, and although its first full year of operations was in 2011, the bank already operates with a balance sheet of $7.8 billion as of March 31, 2013. Barwa Bank has the highest concentration of lending to contractors within the Islamic banks, and at about 15% as of year-end 2012, also has the highest exposure to non-bank financial institutions. Barwa Real Estate Company is the largest shareholder of the bank, followed by Qatar Holding.

Qatar's Small Bankable Population Could Limit The Islamic Banks' Long-Term Growth Prospects

The total asset base of the Qatari banking system reached over $240 billion as of July 31, 2013, and the government's planned infrastructure projects give us reason to believe that the banking system will continue to grow at a fast pace for several more years. However, the total population of Qatar is less than two million, and expatriates and foreign workers represent a predominant portion of this figure. In addition, the latter group tends to have relatively limited assets in the Qatari banking system. Therefore, Qatar's bankable population, as in many other GCC countries, is limited.

Consequently, one of the major questions we have about the Qatari banking system is the whether the pace of growth will slow once the number of government projects falls in future. Over the past 12–18 months, we have seen some of Qatar's most active conventional banks acquiring banking assets in other regional markets, notably Turkey and Egypt. We see a possibility of Qatar's Islamic banks taking a similar approach in the long term, once the credit growth in the country slows to visibly lower levels.

CHART 2
FUNDING BREAKDOWN FOR THE ISLAMIC BANKS*



*As of year-end 2012. Source: The banks' financial statements.

Basel III Regulation Could Prompt The Islamic Banks To Turn Increasingly To The Debt Markets

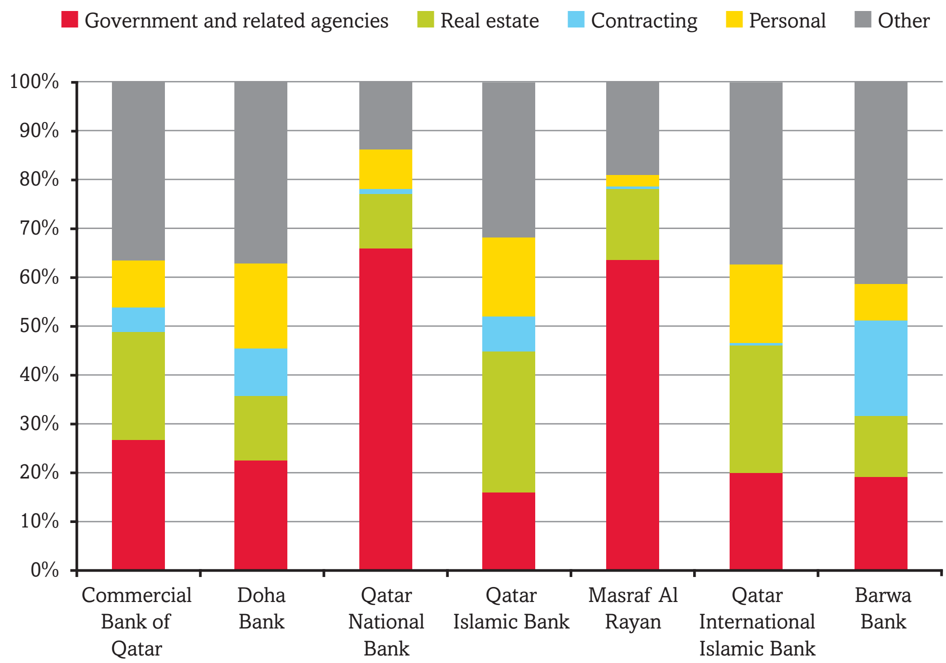
Historically, Islamic banks have not been very active in the debt capital markets, with only Qatar Islamic Bank and Qatar International Islamic having issued sukuk (see chart 2). In addition, the contractual maturity of the deposits collected by the Islamic banks is very short term, whereas the lending tenors are substantially longer. However, we believe that funding and liquidity requirements of the incoming Basel III regulatory standard will move the Qatari Islamic banks to tap the debt capital markets more actively over the next few years and raise longer-term funding.

Accessing the debt capital markets more frequently should in our view diversify the Qatari Islamic banks' funding profiles. About 65% of the Islamic banks' total balance sheet is funded with customer deposits, whereas another 18% is funded with shareholders' equity. At the same time, gross interbank funding on the Islamic banks' balance sheet is limited, at about 12%. The banks' foreign liabilities are similarly limited, representing about 11% of total liabilities as of July 31, 2013. Unlike the conventional banks, the Islamic banks enjoy a net foreign asset position, albeit a limited one, because they fund themselves predominantly from the local deposit market. The domestic credit-to-resident deposits ratio of the Qatari banking system stood at 109% as of July 31, 2013, whereas the ratio is lower for the country's Islamic banks, at 96%.

Qatar's Islamic Banks Have Similar Lending Profiles And Geographical Focus To Their Conventional Peers...

The lending profiles of the Islamic banks are largely on a par with their conventional banking peers (see chart 3 overleaf). Qatar National Bank and Masraf Al Rayan have the largest government

CHART 3
LENDING EXPOSURES OF SELECTED QATARI BANKS*



*As of year-end 2012. Source: The banks' financial statements.

and public sector exposures relative to their lending book (over 60% for each bank), whereas the Commercial Bank of Qatar and Qatar Islamic Bank have the largest real estate lending concentrations. Qatar's Islamic banks also tend to have larger retail lending operations, since the bulk of the lending is to Qatari nationals and secured through payroll.

Historically, the Qatari banking system's growth has largely been driven by the country's large funding needs as a result of its intensive capital expenditure programs. The banking system's credit exposure has therefore been predominantly domestic. For example, as per July 2013 CBQ data, credit outside Qatar constituted only 8.7% of the Qatari conventional banks' total credit book and 5.6% of their total asset base, whereas the banks' total foreign assets was limited to about 20%.

The Islamic banks' focus is even more Qatar-centric than that of the conventional banks. The Islamic banks' credit outside Qatar is limited to 6.3% of the total credit stock, or 4% of the Islamic banks' asset base, as of July 2013. Additionally, the Islamic banks' gross foreign asset position is limited to about 8.3% of the total balance sheet, versus about 20% for the overall sector. This is because a significantly larger portion of the Islamic banks' interbank and investment exposure is within Qatar.

...And Better Asset Quality Than Most Rated Banks In The Gulf

The relative similarity of the Islamic and conventional banks' lending book activities means that their reported nonperforming loan (NPL) ratios and credit losses are also very similar. Masraf Al Rayan has the lowest NPL ratio of the Islamic banks in Qatar, because its lending profile is very similar to that of Qatar National Bank, where over 60% of the gross lending book is to the Qatari government and the public sector entities.

Moreover, the reported NPLs and overall credit losses of the Qatari Islamic banks compare favorably to other Islamic banks that we rate in the Gulf (see table 3). For example, at year-end 2012, the Qatari Islamic banks' NPL ratio was 1.5%, versus 4.0% for all the Islamic banks that we rate in the Gulf. At the same time, the ratio of credit losses and impairments on securities to operating revenues of the Qatari Islamic banks was 9.8%, versus 23.8% for all the Islamic banks we rate.

TABLE 3: ASSET QUALITY AND CREDIT LOSSES--CONVENTIONAL VERSUS ISLAMIC BANKS*

	2009¶	2010	2011	2012
Nonperforming loans to gross loans				
Key conventional Qatari banks	1.4%	1.8%	1.4%	1.4%
Qatari Islamic banks	0.9%	1.5%	1.2%	1.5%
GCC Islamic banks rated by S&P	5.4%	5.7%	4.4%	4.0%
Total GCC banks rated by S&P	4.6%	4.4%	3.7%	3.3%
Credit losses and impairment on securities to operating revenues				
Key conventional Qatari banks	13.5%	10.1%	10.4%	9.1%
Qatari Islamic banks	5.4%	1.0%	5.5%	9.8%
GCC Islamic banks rated by S&P	16.9%	17.9%	17.9%	20.2%
Total GCC banks rated by S&P	37.8%	30.7%	23.1%	23.8%

GCC--Gulf Cooperation Council. *The key conventional banks are Qatar National Bank, Central Bank of Qatar, and Doha Bank. The Qatari Islamic Banks are Qatar Islamic Bank, Qatar International Islamic Bank, Barwa Bank, and Masraf Al Rayan. ¶2009 does not include the results of Barwa Bank, because the bank was established after this date. Source: The respective banks' financial statements.

Having said that, we consider that the Qatari governments' support of the country's banking system in times of financial stress could be distorting this picture. For example, although the reported credit loss experience for the Qatari banking sector during the global financial crisis of 2008–2009 was limited, we note that credit losses in Qatar are not necessarily indicative of the overall quality of the banks' exposures. This is because throughout the financial crisis, the Qatari authorities supported the country's banks significantly by buying back their real estate portfolios or local stock market exposure. We believe that in the absence of this intervention, the banks' actual loss experience would have been much higher, in view of the banks' large lending concentrations and the significant pace of growth that we saw in the years preceding the financial crisis.

Similar to their conventional peers, the Islamic banks in Qatar have high levels of restructured exposures and overdue amounts. This is because of the project-intensive nature of lending in Qatar and the fact that common delays in project financing create temporary cash flow shortages for the obligors, whereupon the banks tend to restructure. Although the reported NPL ratio remains low, if we add on overdue (not recognized as impaired) and restructured exposures, the total amount of questionable exposures--that is, exposures whose quality we wouldn't consider on a par with regular loans--represent about 10% of the Islamic banking sector's gross lending book. We note that this is a common trait of the Qatari banking system. As the bulk of credit is generated for large projects that tend to get delayed, temporary cash flow problems at the obligors generally translate into high overdue balances and renegotiated exposures for the banking system. However, the migration from overdue and restructured to NPLs has traditionally been limited.

Islamic Banks' Margin Contraction Should Stabilize From 2014, Following A Two-Year Decline

Like their conventional peers, the Qatari Islamic banks generate a large portion of their revenues through net interest income (NII). NII represented about 77% of the Islamic banks' operating revenues in 2012, whereas income from fees and commissions was about 11%.

In addition, loan pricing has declined faster than the cost of interest-bearing liabilities over the past two years, and this has resulted in some contraction in the Islamic banks' net interest margins. This was the main reason for a decline in the Islamic banks' operating revenues over their average assets in the past two years (see table 4).

TABLE 4: AN ANALYSIS OF ROE GENERATION FOR QATARI ISLAMIC BANKS

	2010	2011	2012
+ Net interest income to average assets	3.2%	2.9%	2.8%
+ Fee income to average assets	0.7%	0.5%	0.4%
+ Other noninterest income average assets	0.5%	0.5%	0.4%
= Operating revenues over average assets	4.3%	3.9%	3.7%
- Operating cost over average assets	1.2%	1.2%	1.1%
- Credit losses over average assets	0.0%	0.2%	0.4%
- Other items over average assets	(0.1%)	(0.2%)	0.0%
= Return on average assets	3.2%	2.7%	2.2%
*Equity leverage (average equity to average total assets)	4.63	5.14	5.67
= Return on average equity	14.7%	14.0%	12.4

ROE--Return on equity. Source: The Islamic banks' financial statements.

Nevertheless, we do not foresee any additional net interest margin compression for the Islamic banks over the next two years, which should support revenue generation. This is because, like their conventional peers in Qatar, the Islamic banks operate with a relatively low operating cost base and low levels of credit losses, which support healthy returns on assets. We therefore calculate that the banks' earnings profile will remain largely unchanged over the next two years.

Qatari Islamic Banks' Performance Metrics Will Remain Strong

We see the outlook for both the Qatari banking system and its Islamic banks as stable over the next two years. The Qatari government's large infrastructure investments and its highly supportive stance during the global financial crisis of 2008-2009 have enabled the Qatari Islamic banks to benefit from fast-paced credit growth and report strong margins and low credit losses. This, in turn, has led to strong performance metrics, and healthy capitalization and funding and liquidity metrics. We do not envisage this changing over the next two years.

GULF ISLAMIC BANKS CONTINUE TO GROW FASTER THAN THEIR CONVENTIONAL PEERS, BUT PROFITABILITY RATES ARE CONVERGING

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Islamic banks in the Gulf Cooperation Council (GCC) are likely to grow faster than their conventional counterparts and increase their share of GCC banking system assets for the foreseeable future, Standard & Poor's Ratings Services believes. But profitability rates for the two banking models are converging as Islamic banks are taking a more pronounced hit from lower interest rates and non-core banking revenues than their conventional peers because they traditionally operate with larger bases of non-interest bearing liabilities.

According to our analysis of some conventional and Islamic banks in the Gulf region, the GCC Islamic banks in our sample of banks outgrew their conventional peers between 2009 and 2012. Their asset bases showed a compound average growth rate of 17.4% compared with conventional banks' 8.1%, while their net lending and customer deposits grew by an average of 18.2% and 19.9% compared with conventional banks' 8.1% and 10%. Watch the related CreditMatters TV segment titled "Gulf Islamic Banks Continue To Grow Faster Than Their Conventional Peers, But Returns Are Converging With Conventional Banks," dated Oct. 7, 2013.)

OVERVIEW

- GCC Islamic banks continued to capture market share and outgrow their conventional peers despite the 2008 crisis, and we expect them to continue to grow fast.
- Low interest rates and lower capital market-related gains than 2008 pre-crisis levels are impairing revenue growth for most Islamic banks in the region, leading to profitability convergence with their conventional peers.
- Strong government support is the key to the rapid growth of Islamic banking in the region.
- We expect Qatari Islamic banks to grow especially fast because of the country's large infrastructure needs and investments, including the 2022 soccer World Cup.
- We think Islamic banking will continue to increase its market share in the Gulf, and we expect the operating environment over the next two years to remain supportive for Islamic banks' credit quality.

The economies of the countries that make up the GCC--Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates--are showing robust recovery after the 2008 economic crisis, with Qatar looking particularly strong. The region has one of the world's largest Islamic banking markets and the sector has healthy performance metrics. Additional state support means we think Islamic banking in the region will continue to increase its market share, and we expect the operating environment over the next two years to remain supportive for Islamic banks' business and credit quality.

HOW WE REACHED OUR CONCLUSIONS

- For our analysis, we selected only pure-play commercial Islamic banks in the Gulf region with a minimum balance sheet size of $5 billion. We excluded Islamic investment banks whose revenues are primarily driven by capital markets and principle investment-related activities. Four of the Islamic banks in our sample list were established in the past few years, and we incorporated their financials into our analysis from either 2009 or 2010.
- The geographical distribution among individual GCC countries is fairly balanced with Saudi Islamic banks representing 31.4% of our sample size, UAE Islamic banks 24.7%, Kuwaiti Islamic banks 21.6%, Qatari Islamic banks 16.4%, and Bahraini Islamic banks 6%.
- Although we have aggregated metrics for GCC Islamic banks, our sample is heavily concentrated on individual names- Al Rajhi and Kuwait Finance House together represent around 39%, while the largest five banks represent 61% of our 17-bank sample. As our average is heavily influenced by the large banks, we also make specific references to the sample average without these large entities.
- The sample asset size, based on 2012 year-end balance sheets, is around $317 billion. We note that this list is not exhaustive, as it does not include an estimated $30-$40 billion asset base of banks excluded from our analysis. It also does not consider potential Islamic assets held by conventional institutions in the GCC region. Nevertheless, we believe it is very representative of the core Islamic commercial banking market in the region, and its financial trends.

The economies of the countries that make up the GCC--Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates--are showing robust recovery after the 2008 economic crisis, with Qatar looking particularly strong. The region has one of the world's largest Islamic banking markets and the

TABLE 1: SAMPLE ISLAMIC BANKS

Bil. $ as of year-end 2012	Country	Assets	Net loans	Customer deposits	Islamic banking ranking	Overall ranking	% Weight in sample assets
Al Rajhi Bank	Saudi Arabia	71	46	59	1	5	22.5
Kuwait Finance House	Kuwait	52	30	33	2	8	16.5
Dubai Islamic Bank	UAE	26	15	18	3	17	8.2
Abu Dhabi Islamic Bank	UAE	23	14	17	4	20	7.4
Qatar Islamic Bank (S.A.Q)	Qatar	20	12	12	5	25	6.4
Al Baraka Banking Group B.S.C.	Bahrain	19	12	15	6	26	6.0
Masraf Al Rayan	Qatar	17	12	12	7	29	5.3
Bank Alinma	Saudi Arabia	14	10	9	8	32	4.5
Bank Aljazira	Saudi Arabia	14	8	11	9	33	4.3
Emirates Islamic Bank PJSC	UAE	10	5	7	10	35	3.2
Ahli United Bank B.S.C.	Kuwait	9	6	6	11	36	3.0
Al Hilal Bank PJSC	UAE	9	6	7	12	37	2.8
Qatar International Islamic Bank	Qatar	8	4	5	13	38	2.5
Barwa Bank P.Q.S.C	Qatar	7	4	4	14	39	2.2
Boubyan Bank K.S.C.	Kuwait	7	5	5	15	40	2.1
Sharjah Islamic Bank	UAE	5	3	3	16	41	1.6
Noor Islamic Bank P.J.S.C	UAE	5	3	4	17	42	1.5
Total		317	194	228			100.0

Source: Banks' financial statements.

sector has healthy performance metrics. Additional state support means we think Islamic banking in the region will continue to increase its market share, and we expect the operating environment over the next two years to remain supportive for Islamic banks' business and credit quality.

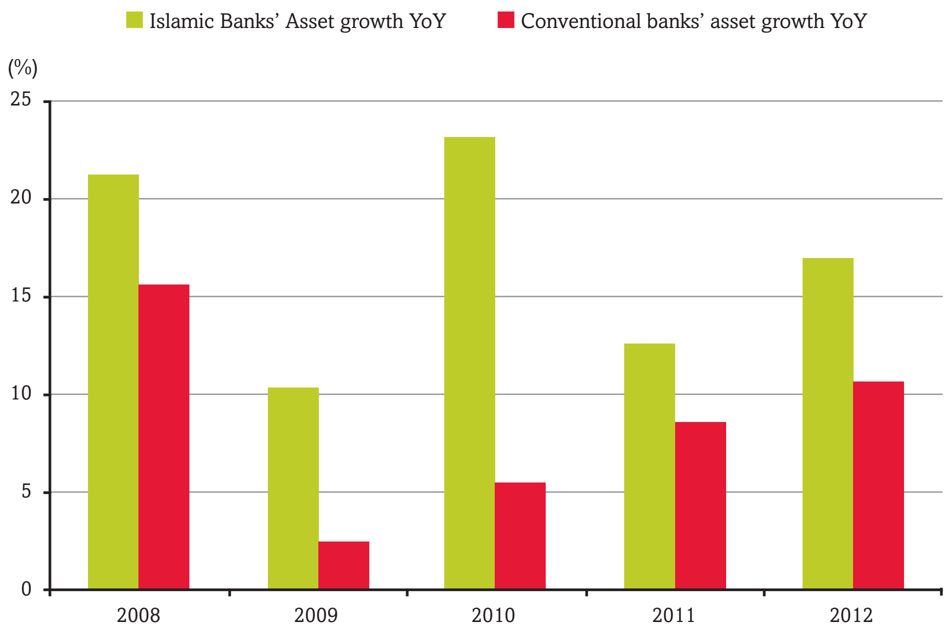
Strong Government Support Is Key To The Rapid Growth Of GCC Islamic Banking

We believe that GCC Islamic banks have grown very fast because of significant direct and indirect support from governments, ruling families, and authorities, and we expect this support to continue (see "Islamic Banking Has Reached Critical Mass In The Gulf After Sustained Growth, And Expansion Is Set To Continue," published on Dec. 4, 2009 on RatingsDirect).

For example, the granting of banking licenses is a discretionary power of the state authorities, and most of the new banks in the GCC region are Islamic. State authorities also control the system allowing conventional banks to change into Islamic ones--Bank of Kuwait & The Middle East in Kuwait, and Sharjah Islamic Bank and Dubai Bank in UAE have all done this. In addition, the authorities control the opening of dedicated business lines in Saudi Arabia, Qatar, and UAE, and the acquisition of Islamic banking subsidiaries, as happened when National Bank of Kuwait S.A.K. acquired a controlling stake in Boubyan Bank.

State authorities have had strong and direct involvement in the development of the Islamic banking sector by holding direct and indirect stakes in Islamic banks including Kuwait Finance House, Dubai Islamic Bank, Dubai Bank, and Al Rajhi Bank, and more recently, Alinma Bank, First Energy Bank, Al Hilal Bank and Barwa Bank. State involvement has been particularly strong in Qatar, where the Central Bank banned conventional banks from having "Islamic windows." The Qatari authorities also structure a large part of their infrastructure funding to be sharia compliant to allow Islamic banks to participate in these projects (see "Qatar's Islamic Banks Are On A Fast Track To Growth" published on Sept. 16, 2013).

CHART 1
ISLAMIC BANKING ASSETS GROWTH VS. CONVENTIONAL PEERS



Source: Banks' Financial Statements.

Differences In Local Credit Conditions Lead To Divergent Islamic Asset Growth Rates

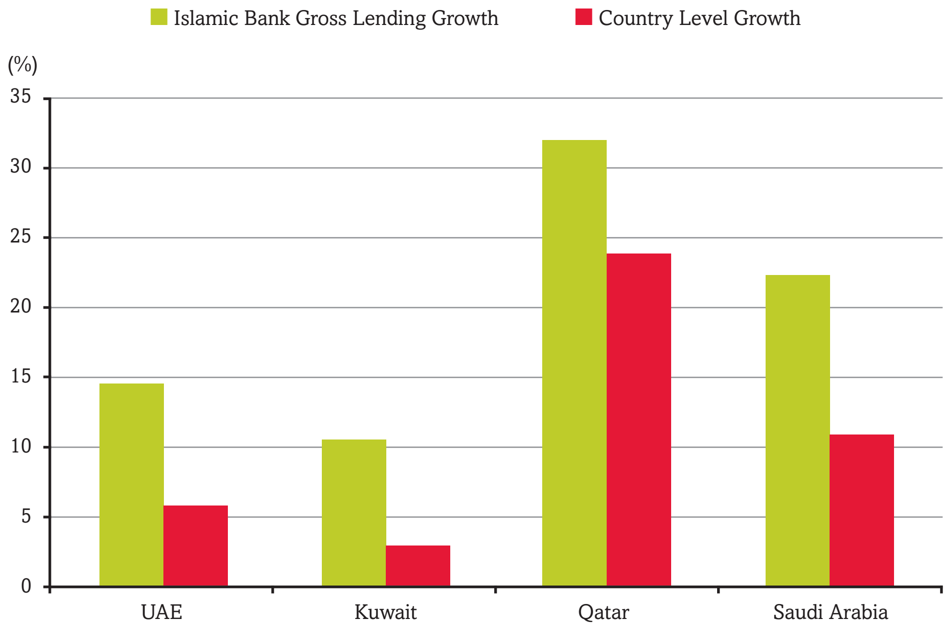
We expect GCC Islamic banks' overall credit growth to remain strong over the medium term, with Saudi and Qatari Islamic banks accounting for a big chunk of the increase because of their planned infrastructure investments. We also think Abu Dhabi-based banks will show healthy growth, given their stronger balance sheets relative to their Dubai-based peers.

GCC banking system assets have risen by a compound average growth rate of 6.9% a year since 2009 to reach $1.6 trillion at the end of 2012, as the positive effects of strong oil prices offset the fragile global operating environment. However, when we look at growth rates among individual countries using our sample of selected banks, we see quite a bit of divergence. The strongest compound average growth rate was in Qatar, where strong state support and a buoyant economy helped Islamic banks expand their loans by 32% compared with system-level domestic credit growth of 23.7%. The country's youngest Islamic bank, Barwa Bank, began operations after 2009. If we were to exclude Barwa Bank from our analysis, the lending growth for Islamic banks would still remain at 26% for the period.

Saudi Arabia was the second-fastest-growing Islamic banking market, with a average 22.3% growth rate in 2009-2012, as banks were able to capitalize on strong local economic conditions. Alinma Bank, the country's newest Islamic bank, began operations in 2008.
The compound average growth rate for the Islamic banks in our sample for the UAE over the same period was around 14.5%, but this falls to 9.3% if we exclude Al Hilal Bank, which began operations in 2011. Most of the growth was generated by Abu Dhabi-based banks and the contribution from Dubai-based banks was minimal as they had to focus on cleaning up their balance sheets due to real estate and government-related entity (GRE) lending exposures

CHART 2

COUNTRY LEVEL GROWTH AMONG KEY MARKETS



Source: Banks' Financial Statements.

In Kuwait, the compound average growth rate of 10.5% was largely driven by Kuwait Finance House, whose rise came mostly from overseas businesses, predominantly in Turkey. That's why Islamic banking growth was significantly above domestic credit growth.

Bahrain has experienced political and economic upheaval over the past two years, and central bank data show total assets for Islamic retail and wholesale banks unchanged at $25.5 billion from 2009-2012. Total Bahraini banking system assets contracted by about 16% between 2009 and 2012.

In Oman, the regulator approved Islamic banking from Jan. 1, 2013. The country's first Islamic bank, Bank Nizwa, opened in January 2013. Oman's biggest lender, Bank Muscat, has begun to sell Islamic banking products through an Islamic window. Despite this recent push, we do not expect the Islamic banking segment in Oman to represent a meaningful portion of the regional Islamic banking market because Oman's banking system, at around $37 billion at the end of 2012, is small.

Country-Specific Asset Quality Trends

Asset quality trends for GCC banks are driven by country-specific factors rather than conventional or Islamic structure. We selected 26 conventional banks in the Gulf region for our conventional banking sample and the total asset base of the sample banks was $1 billion as of year-end 2012.
Although the conventional banks started 2008 with significantly lower nonperforming loan (NPL) stock than their Islamic banking peers, they experienced much faster asset quality deterioration than the Islamic banks during the first year of the crisis. Their average NPL ratio rose from 1.7% in 2008 to 4.3% in 2009 while Islamic banks' rose to 5.2% in 2009 from 4.4% in 2008. This higher rate for conventional banks is largely a result of UAE banks' increasing NPL levels in 2009--around 36% of new NPL formation in 2009 came from UAE-based banks. It also reflects the significant hike in Kuwait-based Gulf Bank's

TABLE 2: ASSET QUALITY COMPARISON BETWEEN ISLAMIC AND CONVENTIONAL BANKS

Conventional banks	2008	2009	2010	2011	2012
NPL ratio (%)	1.7	4.3	5.1	4.9	4.6
NPL coverage (%)	129.0	79.5	75.1	75.0	80.5
Credit losses % average assets	1.1	1.2	0.9	0.7	0.6
Credit losses to revenues	27.6	30.9	23.0	18.6	17.5
Islamic banks	**2008**	**2009**	**2010**	**2011**	**2012**
NPL ratio (%)	4.4	5.2	5.7	5.6	4.9
NPL coverage (%)	70.7	73.6	69.9	73.8	77.9
Credit losses % average assets	1.1	1.3	1.0	1.1	0.9
Credit losses to revenues	19.1	27.8	24.2	25.6	21.8

NPL--Nonperforming loans. N.A.--Not available. Source: Banks' financial statements.

NPLs in 2009. Looking at our sample of banks, GCC conventional banks' NPLs peaked in 2010 at 5.1%, then gradually declined in the following two years to 4.6% level, whereas for the Islamic banks, the NPL ratio peaked in 2010 at 5.7% level, declining to 4.9% in 2012.

Despite the conventional banks' faster NPL formation, they entered the crisis in 2008 with substantially higher loan loss reserve coverage of 129% versus 71% for their Islamic peers. Given this buffer, conventional banks' overall declines in credit losses after 2009 were significantly better than their Islamic peers. For example, conventional banks' credit losses to average assets peaked at 1.2% in 2009 and gradually declined to 0.6% in 2012, whereas the same ratio, which peaked at 1.3% for Islamic banks in 2009, only declined by 0.4% over the next three years. This had a large impact on performance divergence between commercial and Islamic banks after the crisis.

In our view, the crisis clearly showed that GCC banks' asset quality is influenced more by their country of domicile and local market lending conditions than their adherence to the conventional or Sharia-compliant banking model. Table 3 shows that NPL formation in UAE and Kuwait was very high in 2008 and 2009 because of falling prices on their large real estate exposures, difficulties faced by certain GREs in Dubai, and the challenges faced by local investment companies in Kuwait. We believe the countries' Islamic banks' asset quality trends closely followed these leads.

We see large real estate lending concentrations in Kuwait, Qatar, and UAE for most banks, including Islamic banks. Some Islamic banks also have direct investments in real estate as an asset class, and this has created volatility in their earnings and overall performance since the 2008 crisis.

TABLE 3: NON-PERFORMING LOANS BY GEOGRAPHY (%)

	2008	2009	2010	2011	2012
Kuwait--Islamic banks	8.6	8.2	9.4	7.0	5.9
Kuwait--all banks	6.2	10.6	8.5	6.6	5.3
Qatar--Islamic banks	1.0	0.9	1.5	1.2	1.5
Qatar--All banks	0.9	1.3	1.7	1.4	1.5
KSA--Islamic banks	2.3	3.8	2.5	1.8	1.9
KSA--All banks	1.6	3.4	3.0	2.4	2.0
UAE--Islamic banks	3.6	5.4	7.4	11.4	10.3
UAE--All banks	1.4	3.7	6.7	8.2	8.4

Source: Banks' financial statements.

Deposits Are The Main Source Of Funding, And Overseas Borrowing Is Very Limited

Most GCC banks have traditionally funded themselves through customer deposits, and the overall role of non-depository funding is limited. This is more visible with Islamic banks, where debt capital markets issuance has historically been very limited.
About 72% of Islamic banks' total assets were funded by customer deposits as of Dec. 31, 2012, and 14% were funded by shareholders' equity. Most GCC banks also have high levels of non-remunerated current

TABLE 4: ASSET FUNDING COMPOSITION OF ISLAMIC BANKS AND CONVENTIONAL BANKS

Islamic Banks Asset Funding Composition (%)	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Core Deposits	68.0	68.4	69.4	67.6	68.5	70.0	72.0
Non core deposits	8.0	8.3	9.2	8.4	9.9	9.1	7.7
Other borrowing	1.5	1.7	1.6	1.8	2.3	2.1	2.6
Other liabilities	5.5	4.8	4.5	5.3	3.9	3.9	3.8
Total Equity	16.9	16.8	15.3	16.8	15.5	14.9	13.9
Conventional Banks Asset Funding Composition (%)	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Core Deposits	66.2	62.1	64.8	65.4	66.7	66.7	68.5
Non core deposits	12.7	16.8	13.9	12.0	10.1	10.6	8.9
Other borrowing	6.1	6.6	6.3	6.8	6.3	5.8	5.9
Other liabilities	3.2	3.4	3.9	3.3	3.6	3.5	3.4
Total Equity	11.8	11.1	11.0	12.5	13.3	13.5	13.4

Source: Banks' financial statements.

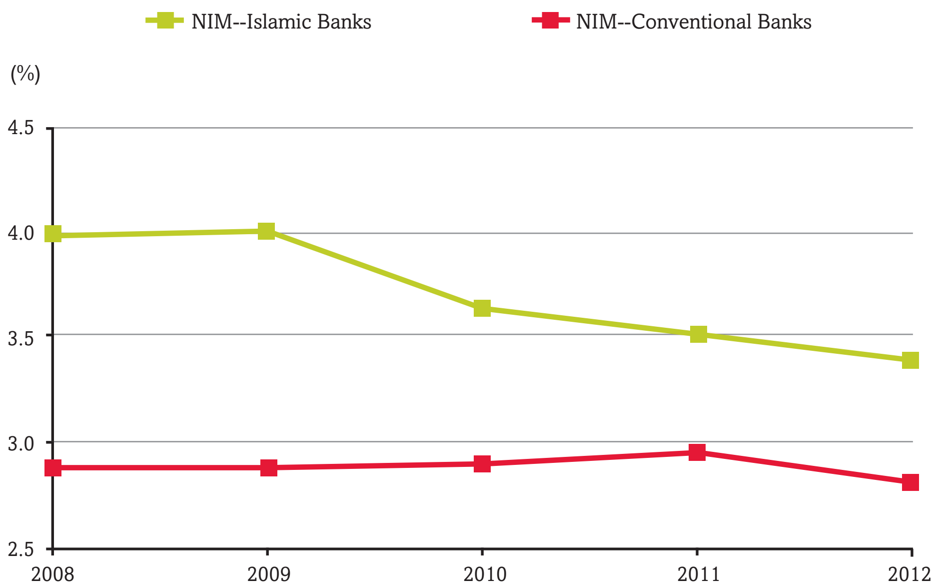
accounts, and Islamic banks generally have stronger access. In addition, most Islamic banks in the region traditionally employ more capital than their conventional peers in funding their assets.

Given the larger equity base and current account deposits, Islamic banks' interest bearing liabilities to total liabilities are generally lower than their conventional peers.

The Gulf region's currencies, with the exception of Kuwait, as its currency is pegged to an undisclosed basket of currencies, are pegged to the U.S. dollar, so regional interest rates have tracked the decline in global interest rates over the last few years. Islamic banks are able to operate with strong net interest margins in a high interest rate environment because of their funding advantage. The impact of declining interest rates was therefore more obvious on their performances. Conventional banks were able to mitigate some of the pressure on their yields on earning assets as they were able to capitalize on the lower cost of funding opportunities in debt capital markets.

CHART 3

GCC BANKS' NET INTEREST MARGIN (NIM) EVOLUTION



Source: Banks' Financial Statements.

The corporate and infrastructure related nature of lending in the Gulf region means the average tenor of loans for most Islamic banks is substantially higher than a year. Furthermore, the average tenor for customer deposits is generally very short-term. This results in a contractual asset liability mismatch for Islamic banks similar to their conventional peers. Although these deposits have a very high roll-over rate, we believe that under the incoming Basel III regulations, the region's banks will be further incentivized to issue longer term paper. We therefore expect Islamic banks in the region to adopt a more active stance in debt capital markets.

Islamic Banking Returns Are Converging With Their Conventional Peers

Unless we see a cycle of higher interest rates that would help Islamic banks to expand their net interest margins, we expect to continue to see convergence between conventional and Islamic banking returns in the GCC region over the next few years.

Islamic banks have continued to outgrow their conventional peers since the beginning of the crisis, but their margins have been eroding and their return on average assets converging with conventional banks. Between 2008 and 2012, Gulf Islamic banks' average return on average assets declined by around 100 basis points (bps), and operating revenues to average assets declined by 130bps. The main driver behind the lower revenue generation was the significant contraction in net interest margins, but this was also accompanied by a significant contraction in revenues some Islamic banks had traditionally generated from non-core banking activities. These factors mean that Islamic banks' revenue generation is now falling to their conventional counterparts' levels.

Conventional banks have been able to reduce their provisioning requirements substantially since

TABLE 5: ANALYSIS OF ISLAMIC BANKS' RETURN ON EQUITY (%)

	2008	2009	2010	2011	2012	Change from 2008 to 2012
Net interest income to average earning assets	4.0	4.0	3.6	3.5	3.4	(0.6)
Average earning assets to average assets	87.4	87.6	87.3	86.5	86.3	(1.1)
Net interest income to average assets (1)	3.5	3.5	3.2	3.0	2.9	(0.5)
Fee income to average assets (2)	1.0	0.8	0.8	0.8	0.8	(0.2)
Other non interest income average assets (3)	1.0	0.5	0.3	0.5	0.5	(0.6)
Operating revenues over average assets (= 1 + 2+ 3)	5.5	4.8	4.3	4.3	4.2	(1.3)
Personnel expenses to average assets (4)	1.1	1.1	1.0	1.0	0.9	(0.2)
Non personnel expenses to average assets (5)	0.8	0.9	0.9	0.9	0.8	0.0
Operating cost over average assets (=4+ 5)	2.0	2.0	1.9	1.9	1.8	(0.2)
Credit losses over average assets	1.1	1.3	1.0	1.1	0.9	(0.1)
Other items over average assets	(0.2)	(0.4)	(0.3)	(0.4)	(0.2)	0.0
Return on average assets	2.7	1.9	1.7	1.7	1.7	(1.0)
Equity leverage (avg. equity to avg. total assets)	15.0	15.1	15.1	14.2	13.5	(1.5)
Return on average equity	18.0	12.6	11.3	11.9	12.5	(5.5)

Source: Banks' financial statements.

TABLE 6: ANALYSIS OF CONVENTIONAL BANKS' RETURN ON EQUITY (%)

	2008	2009	2010	2011	2012	Change from 2008 to 2012
Net interest income to average earning assets	2.9	2.9	2.9	3.0	2.8	(0.1)
Average earning assets to average assets	88.7	89.3	88.3	88.3	88.5	(0.2)
Net interest income to average assets (1)	2.6	2.6	2.6	2.6	2.5	(0.1)
Fee income to average assets (2)	0.9	0.8	0.8	0.7	0.7	(0.2)
Other non interest income average assets (3)	0.4	0.5	0.4	0.4	0.5	0.0
Operating revenues over average assets (= 1 + 2+ 3)	3.9	3.8	3.7	3.7	3.7	(0.2)
Personnel expenses to average assets (4)	0.8	0.7	0.7	0.7	0.7	(0.1)
Non personnel expenses to average assets (5)	0.5	0.5	0.5	0.5	0.5	(0.0)
Operating cost over average assets (=4+ 5)	1.3	1.2	1.2	1.3	1.2	(0.1)
Credit losses over average assets	1.1	1.2	0.9	0.7	0.6	(0.4)
Other items over average assets	0.1	0.0	0.1	(0.0)	0.1	(0.0)
Return on average assets	1.4	1.4	1.6	1.8	1.7	0.3
Equity leverage (avg. equity to avg. total assets)	10.5	10.7	11.6	12.4	12.7	2.2
Return on average equity	13.6	12.9	13.5	14.5	13.7	0.1

Source: Banks' financial statements.

NPL formation began to stabilize, as they entered the crisis with substantially higher loan loss reserve coverage. Islamic banks have continued to operate with higher levels of credit losses, which has also contributed to the convergence of Islamic and conventional banks' profitability.

As with asset quality, profitability depends significantly on country of operations, so banks in Qatar and Saudi Arabia are operating with better metrics than their peers in the UAE and Kuwait.

We believe the convergence of returns between the conventional and the Islamic banking models in the GCC region is here to stay. Islamic banks used to be able to rely on strong returns from non-banking activities such as capital markets and real estate owing to the inflationary asset valuation cycle in the region. After their recent credit losses we now expect them to have similar provisioning levels to their conventional peers.

TURKEY'S GROWING ISLAMIC BANKING SECTOR NEEDS FRESH CAPITAL FOR AN ADDED PUSH

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"Participation banks" (the official name of Islamic banks in Turkey) look set to keep increasing their market shares over the medium term, after posting exceptional growth between 2008 and 2012. However, sluggish domestic savings and intensifying competition from conventional banks will likely limit the sector's progress without fresh capital and funding, Standard & Poor's Ratings Services believes.

Several factors contributed to the growth of the country's four participation banks, not the least of which is local authorities' more supportive stance toward the sector. Notable examples of this are the Turkish Treasury's debut revenue-indexed bonds in 2009 and a sukuk in 2012. This led to improved legislative infrastructure that has opened up new avenues of investment for participation banks. Building on this, the participation banks have issued their own inaugural sukuk over the past three years, among them Tier 2 sukuks that have been instrumental in sustaining some banks' capital adequacy ratios as they expand.

These developments have not only attracted more funds to the sector from cash-rich countries in the Gulf Cooperation Council (GCC), but also provided opportunities for participation banks to diversify their balance sheets. Over the past four years, the banks have extended their branch networks, which contributed to market-share gains of about two percentage points in deposits and 1.5 percentage points in assets. The sector's current market share, in terms of assets, stands at 5.4%. Nevertheless, we believe that further gains would require additional capital.

OVERVIEW

- In our view, the Turkish government's initiatives allow participation banks (also called Islamic banks) to diversify their asset and funding bases and attract international investors.
- However, we believe the banks' Tier-2 capital issuances will lose pace as foreign investors' enthusiasm for bank debt in emerging markets lessens.
- We also see intense competition from conventional banks, and possibly from new entrants, making ongoing funding support and fresh capital crucial for future growth.
- In addition, participation banks' rapid growth and high exposure to the construction sector render their asset quality vulnerable to an economic slowdown.

We believe the government will continue to take steps that help the segment capture a larger share of Turkey's relatively under-banked market. This year, for example, the government has announced its intention to launch greenfield Islamic banking subsidiaries at state-owned banks. In our view, this would boost the aggregate market share of the still-tiny sector over the long term, although the new entrants, including any with foreign owners, will compete against existing players. We believe the growth momentum existing participation banks have enjoyed can continue only if their capital bases increase and they achieve some competitive advantage.

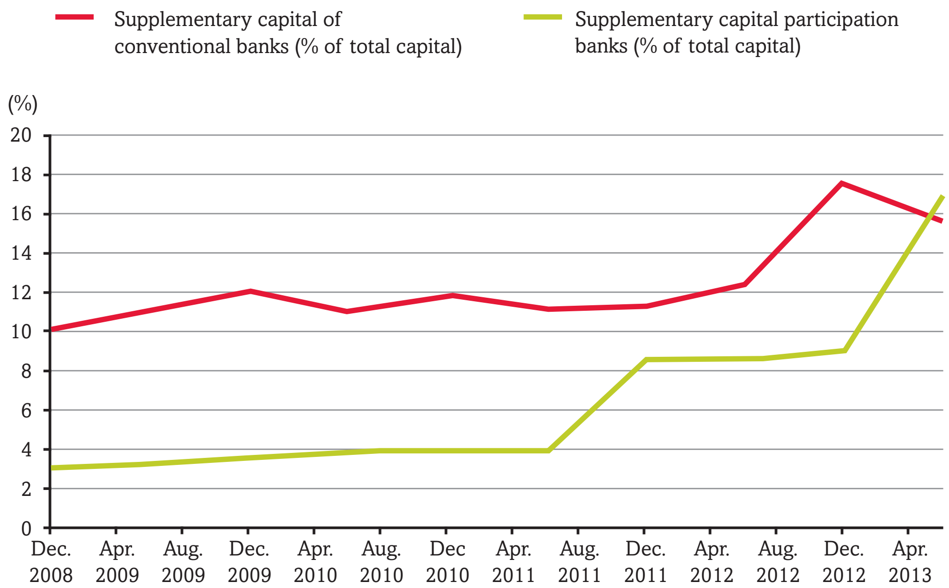
Maintaining good asset quality through a period of rapid growth is another challenge for the sector, in our view. Our base-case scenario for the Turkish banking system already factors in a slight deterioration of nonperforming loan ratios, which are still in the low single digits. But we believe participation banks remain more vulnerable than conventional banks in a downturn.

Growth Can No Longer Rely On Tier 2 Capital

In our view, a key hurdle will be raising the capital needed to support growth. Consolidated data from Turkey's Banking Regulatory Supervisory Authority (BRSA) for 2008-2012 show that, over the past five years, participation banks' aggregate regulatory capital adequacy ratio (CAR) ranged from 15.2% (at year-end 2008) to 13.7% (at year-end 2012). This 1.5 percentage point deterioration of the ratio indicates that the banks' rapid expansion in 2008-2012 came at the expense of their capital buffers.

Turkish banks remedied some of the erosion with supplementary capital issuances, in particular, over the past 18 months. From January 2012 to June 2013, the Islamic banks tripled their Tier 2 capital to Turkish lira (TRL) 1.6 billion (about $830 million), or 17% of their aggregate capital base. This compares with an increase of 1.8x for conventional banks during the same period (see chart 1).

CHART 1
TURKISH PARTICIPATION BANKS RELIANCE ON TIER-2 CAPITAL VS. CONVENTIONAL BANKS



Source: Turkish Banking Regulatory Supervisory Authority.

Tier 2 issuances, notably in the first half of 2013, helped the participation banking sector boost its systemwide regulatory CAR to 14.8%, despite concurrent credit growth of 17%. This figure compares adequately with the minimum regulatory CAR set by the BRSA; a Turkish bank is solvent if it meets the 8% minimum CAR requirement, but is not allowed to open new branches or issue domestic debt if its CAR is below 12%.

However, we believe that such issuances could falter in 2014. The main reason is that the cost advantage participation banks benefitted from before mid-July 2013, when the U.S. Federal Reserve Bank announced its intention to reduce its bond purchases, has dissipated. The Fed has since maintained the level of bond purchases, and the timing of the scale-back is uncertain.

Already, we see a striking difference between the coupon prices of sukuks and those of Turkish treasury debt. The Turkish treasury's debut sukuk in September 2012 carried a coupon rate of 2.80%, whereas one issued in October 2013 has a coupon price of 4.56%.

Foreign Ownership Could Make A Difference

We believe participation banks could take a bigger step forward with the help of foreign owners, barring competition from potential new sector entrants. Based on recent rapid credit growth and banks' ambitious targets, we expect that over the next 12-18 months the sector will likely consume the additional capital cushion stemming from Tier 2 issuances. Therefore, further market gains would hinge on fresh capital.

An important factor distinguishing participation banks from other banks in Turkey is their higher foreign ownership. Of the four players in the sector, three are majority owned by banks based in the GCC (see table 1). As such, about 70% of the sector's assets are under the control of foreign owners. This compares with a mere 15% for conventional banks, or 37% including the assets of the two large banks jointly owned by foreign and Turkish entities.

TABLE 1: TURKISH PARTICIPATION BANKS--AMOUNT OF FOREIGN OWNERSHIP

Bank	Controlling parent	Country	Parent's ownership stake (%)
Albaraka Turk	Albaraka Banking Group	Bahrain	55.00
Bank Asya	Domestic owners	N/A	--
Kuveyt Turk	Kuwait Finance House	Kuwait	62.20
Turkiye Finans Katilim	The National Commercial Bank	Saudi Arabia	65.60

N/A--Not applicable. Source: Banks' financial statements.

We believe this aspect of participation banks could contribute to a change in the banking landscape in the future. With the support of their foreign owners, participation banks could shore up their capital, giving them the flexibility to go after higher market shares. Early this year, Kuveyt Turk received a capital injection of TRL360 million from Kuwait Finance House. This amount is quite significant because it made up about 17% of the bank's shareholders' equity on June 30, 2013. Kuveyt Turk has announced that it expects another injection of the same amount before September 2014. Another example is Turkiye Finans Katilim, which is 65% owned by Saudi Arabia-based National Commercial Bank. Turkiye Finans Katilim's owners injected TRL275 million in two tranches, one in October 2012 (TRL150 million) and another in February 2013 (TRL125 million).

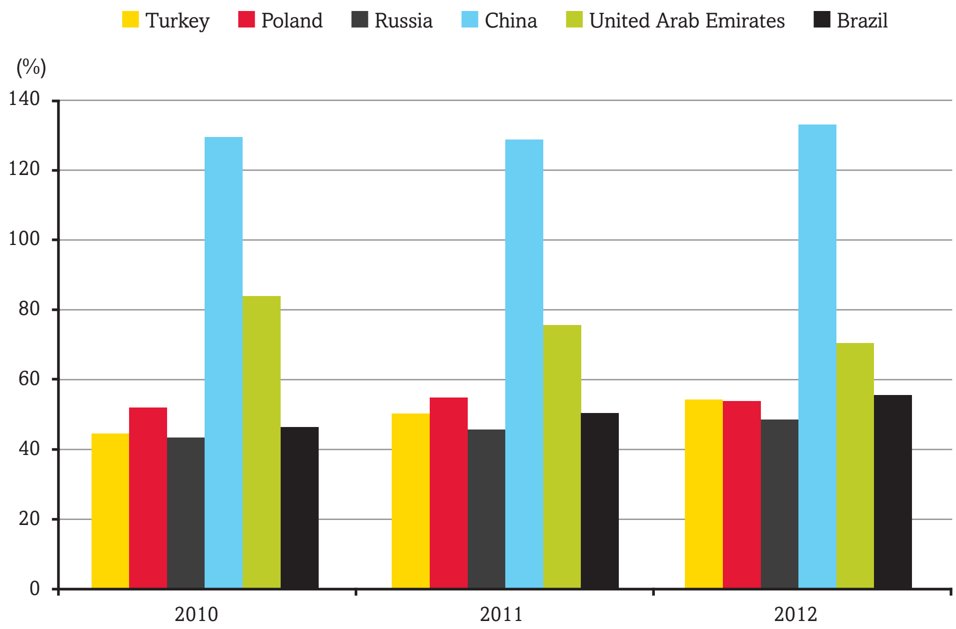
Moreover, we expect ongoing funding support from foreign owners to play an important role in helping existing players expand, particularly given Turkey's still developing debt markets and low savings rates. In the recent past, Turkish banks have tried to fill their funding gaps by increasing external funding (see "Loan Growth And Low Domestic Savings Are Stretching Turkish Banks' Funding Profiles," published on Dec. 5, 2012). Although participation banks have followed suit, their funding sources are less sensitive to investor confidence because a relatively higher proportion of their external debt comes from their owners.

Conventional Banks And Potential Newcomers Are Rivals

Over the medium term, competitive dynamics will likely test existing participation banks' ability to rapidly increase their market shares. Not only do they have to contend with conventional players, but also the threat of new entrants. The highly competitive environment stems from the low degree of financial intermediation in Turkey. At year-end 2012, total domestic credit to the nonbank private sector represented 55% of GDP, which is on par with Poland and Russia but far below that in China or the United Arab Emirates (see chart 2).

CHART 2

COUNTRY COMPARISON--DOMESTIC CREDIT AS A PERCENTAGE OF GDP*



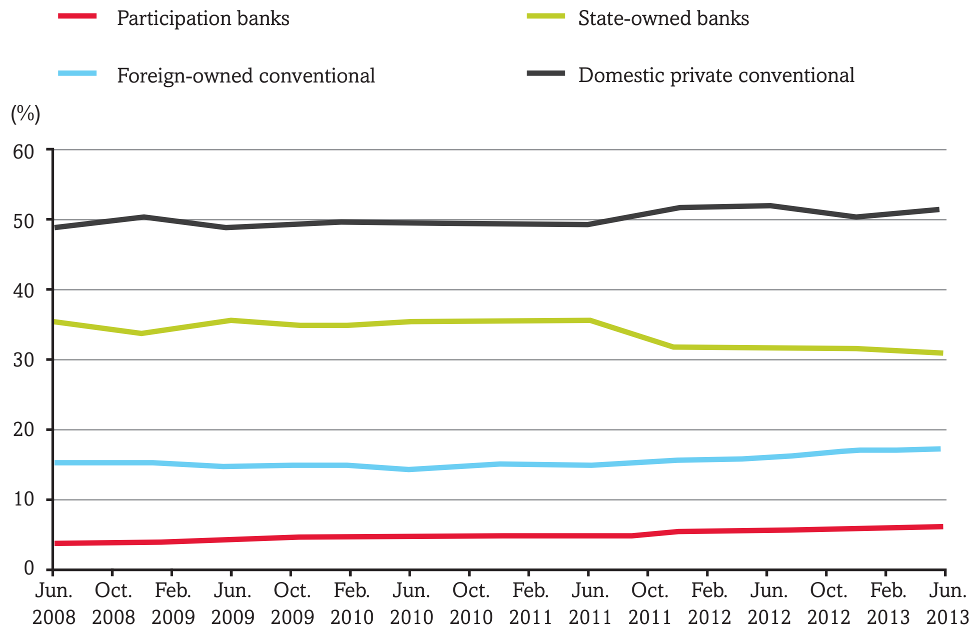
*Domestic credit refers to credit to the private sector and to nonfinancial public-sector enterprises.

Turkey has 49 banks, and the 10 largest commercial banks accounted for about 85% of the system's assets on June 30, 2013. Competitive dynamics in the industry, to a large extent, reflect the activities of a few large privately owned banks that offer a broad range of products, as well as continuous innovation. Over the past decade, these banks have shown a fair degree of resilience to foreign entrants and maintained their hold on the market. Similarly, the evolution of market shares since 2008 suggests to us that private banks have fared well against participation banks (see chart 3 overleaf). We believe competition from this segment will remain strong, leaving little room for participation banks to solidify their market positions.

Official systemwide data on deposits suggest that the participation banks' expansion was to the detriment of state-owned banks. However, it remains to be seen whether this trend will continue in the medium term. In several recent statements, the Turkish government has announced its intention to establish participation bank subsidiaries for state-owned banks.

State officials have indicated that Halk Bank will take the lead by launching a subsidiary with initial equity of TRL300 million. Although the new entity will increase the size of the sector, it would also be an additional competitor for Islamic banking business, increasing the potential for cannibalization. One

CHART 3
TURKISH BANKING INDUSTRY--EVOLUTION OF MARKET SHARE IN DEPOSITS



of Halk Bank's key competitive advantages is its immense branch network, which extends to the most remote parts of Turkey. That said, it is unclear whether the Islamic subsidiary will be using its parent's distribution channels. If not, the new entity will have to invest heavily in branch expansion to compete on the same level as existing participation banks.

A new chapter started for participation banks in 2009

The development of Turkey's participation banking segment accelerated in 2009, when the Turkish Treasury issued debut revenue-indexed bonds (RIBs). The coupon on a RIB is not a fixed interest rate. Rather, coupon payments are indexed (or linked) to the revenue transfers of state-owned enterprises, making RIBs suitable assets under Islamic law. As a result, Islamic banks were able to invest in domestic government debt for the first time since 1984, when Turkey's first participation bank opened for business. But not all of them did so.

Last year, the treasury made yet another debut issue, this time sukuk lease certificates. This allowed all participation banks to invest in government debt, as they regard this instrument as being in accordance with Islamic finance principles.

In our view, these sovereign debt issuances have somewhat alleviated an intrinsic problem in the sector: inability to invest in domestic government debt. Before 2009, participation banks' earning assets comprised customer financings and placements with the central bank and in the interbank market. Sovereign and private-sector debt from issuers in the GCC rarely featured on Turkish participation banks' balance sheets because the yields were typically far lower than the cost of funding.

Credit Risks From Rapid Growth Could Derail Progress

In our view, the participation banks' Achilles' heel over the medium term is asset quality. This is mainly due to a large amount of unseasoned loans and higher exposure to the construction industry than conventional Turkish banks. The rapid growth of the past four years has increased the banking system's vulnerability to an economic slowdown. But, in our view, participation banks are more exposed than their conventional peers because of much faster credit growth over this period. Systemwide data from the BRSA suggests to us that participation banks' total loans increased more than threefold in the 4.5 years up to June 30, 2013, versus 2.5x for conventional banks.

In particular, we remain cautious about residential development projects in which banks participate through a profit-sharing scheme ("musharaka" under Islamic principles). We also note that the share of such projects in banks' credit exposure (including direct financing and musharakas) is rising.

Positively, Turkish authorities have been increasingly proactive, in our view. They have curtailed banks' lending, notably to households, which has been fuelling the sharp increase in domestic credit since 2009. Although we expect relatively slower credit growth over the medium term, loan books remain unseasoned, especially those of participation banks.

In our view, if the sector can sustain growth without loosening lending and underwriting standards, it might avoid some of the pitfalls that eroded the asset quality of some Islamic and conventional banks in the GCC.

DIFFERENTIATING BETWEEN A WEAK AND AN ADEQUATE ENTERPRISE RISK MANAGEMENT ASSESSMENT FOR INSURERS IN DEVELOPING MARKETS

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When it comes to enterprise risk management (ERM) for insurance and reinsurance, Standard & Poor's Ratings Services does not believe that one size fits all. A complex group or a company writing high-risk, high-volatility lines needs a commensurately more-sophisticated system of risk management and exposure modeling. However, simpler, more-traditional, and less-expensive risk management processes may be appropriate for less-complex groups writing low-volatility, low-severity lines in well-understood sectors.

In developing markets, such as the Middle East and Central and Eastern Europe, this issue comes into focus. As it expands, each insurer or regional reinsurer must identify when the complexity of its risk exposure has developed to a point where existing risk management processes are no longer sufficient.

In terms of our rating analysis, the question becomes: When would we consider classifying a company's ERM as weak, rather than adequate? In our criteria, we state that "our assessment of ERM examines whether insurers execute risk management practices in a systematic, consistent, and strategic manner across the enterprise that effectively limits future losses within the insurers' optimal risk/reward framework." This article aims to clarify this definition for non-ERM specialists.

Standard & Poor's Methodology For Analyzing And Assessing ERM

At Standard & Poor's, we classify a company's ERM at one of five levels: very strong, strong, adequate with strong risk controls, adequate, or weak. Weak indicates that serious concerns exist and may have adverse rating implications. However, an adequate assessment would normally be regarded as neutral to the rating outcome. We assess as positive, neutral, or negative each of the five elements of ERM that we review:

- Risk management culture: strength of risk governance, risk appetite framework, and risk reporting processes.
- Risk controls: the processes and procedures used to manage risk.
- Emerging risk management: how management addresses risks that are not yet a threat.
- Risk models: the use of models to measure risks.
- Strategic risk management: how risk considerations affect strategic decisions and how insurers optimise their risk return profile.

If either risk management culture or risk controls are negative, then overall ERM will be assessed as weak. If risk controls are assessed as positive, and all other factors are neutral, then we will assess ERM as adequate with strong risk controls. If risk controls and risk management culture are both viewed as neutral, then the overall ERM score will be adequate, even if any of the other three risk elements are assessed as negative.

Our strong and very strong assessments are beyond the scope of this article, but both of these higher classifications generally reflect a growing number of positive scores in the principal areas of risk management, and an absence of negative scores (for further details, see “Enterprise Risk Management,” published on May 7, 2013, on RatingsDirect).

The initial stage in our ERM assessment process is to decide whether ERM is of high or low importance to the overall financial strength profile of the company under review. In our experience, ERM is of relatively low importance for most developing market insurers, but we regularly regard ERM importance as high for regional reinsurers. In the majority of cases, we assess ERM as adequate--it is rare for us to classify a company’s ERM as weak. Clearly, the greatest concerns arise where we classify a company’s ERM as both weak and of high importance.

Sorting Adequate From Weak ERM

To achieve an at least adequate overall ERM assessment, an insurer’s risk management culture and risk controls must be capable of being assessed as at least neutral under our methodology. So what characteristics of risk management culture and of risk controls can lead us to assess these factors as negative, and thus trigger a weak overall assessment of ERM?

Signs of weakness

The various tell-tale signs of potential weakness in a risk management culture often include:

- There is no risk management function.
- There is a risk management function, but it has a limited influence on how the company is run.
- The main board of directors and the higher echelons of executive management pay little attention to risk issues.
- The insurer cannot, or does not, consider how various risks accumulate.
- There are signs that an insurer lacks a clear understanding of its own risk profile or risk appetite. For example, there is no regular risk reporting, and management does not have an up-to-date view of the company’s risk exposure.

As regards risk controls, there is potential weakness, in our view, when:

- An insurer or reinsurer fails to identify and monitor certain of its main risks.
- There are no formal risk limits.
- The risk limits that do exist are so flexible or large as to be of little practical value in controlling risk exposures.
- Risk limits are not strictly enforced, or if breaches of the limits are either frequent or prolonged.

Some Regional Examples Of Risk And ERM Weakness

Our experience across many developing markets in Europe, the Middle East, and Africa suggests that most insurers and reinsurers are quite good at writing the business they know well. As a result, routine underwriting is rarely a major problem. However, we have identified a number of risks which can throw insurers off balance. Because of that, we consider in our analysis how effectively insurers address these and other risks. The following considerations are therefore important for us when determining whether an insurer's ERM is weak or adequate:

- Regulatory: How companies ensure compliance with often-changing regulatory requirements, and thereby avoid fines or the suspension of their licenses.
- Investment: How an insurer assesses whether its investment strategy is appropriate to its capital position or liability profile. Additionally, when investing in new instruments, how an insurer demonstrates that it fully understands the risk characteristics of the new asset or asset class.
- Expansion: How the risks of expanding the client base, introducing new products, entering new markets, or making acquisitions are assessed and reflected in company strategy.
- Catastrophe: Whether an insurer adequately captures catastrophe risks, e.g., floods, earthquakes, and windstorms--especially when there are no well-established vendor models available to simulate these risks.
- Political: How an insurer prepares and responds to abrupt political or regime change, notably future equivalents of the Arab Spring in the Middle East and North Africa, or the rapid political and economic change in Central and Eastern Europe.
- Accumulations: How an insurer captures risk dependencies, i.e., when one event can lead to claims arising from differing parts of the underwritten portfolio, or under various lines of business.
- Fraud: How internal controls minimize the risk of large fraud losses.
- Technology: How an insurer minimizes the risk of losses due to information technology system break down or loss of data.
- Reinsurance: When, for example, an insurer performs a fronting role for a large local risk, how does it ensure that the residual risks (i.e., those not covered by the reinsurance contract) are adequately accounted for? In addition, how does it take into account the risk that a local court may find the fronting insurer liable for a large, contested insurance claim, but the reinsurer denies the liability and refuses to pay its share of the loss?

Roadblocks To Developing An Effective Risk Management Culture

One problem we periodically identify in the Middle East and certain other regions is that a board of directors may allow deference to a dominant figure or figures to discourage other board members from performing their duty to question and refine the company's evolving strategies, particularly when this lack of questioning is found to extend to areas relating to risk management. We may consider the risk culture of such insurers as weak. Respect for someone who may be of high social standing or who may have founded the company should not overshadow the need to question the status quo and promote constant improvement in corporate governance, risk management, systems, and controls. We still occasionally see weak boards allowing dominant members to set the agenda; in such cases there may be little discussion or consideration of risk management. In some cases, the often-entrepreneurial spirit of such dominant figures can help bring short-term success, particularly when macroeconomic trends are positive. However, when market conditions deteriorate or when the company expands without developing the ability to manage the administrative demands of growth, problems can ensue.

Boards also need to consider the messages they are sending to those lower down in the organization's hierarchy about the importance of complying with risk limits and controls. We see companies where the message is confined to the need for growth or, more complacently, that all is going well and, implicitly, that there is no need for improvement. Meanwhile, some managers and staff are not always clear that it is their duty to contact appropriate superiors if they detect unusual patterns or items within the routine flow of claims, premium, or investment instructions that cross their desks. These inhibitions occasionally stem from a fear of retaliation by more senior colleagues. Where they exist, we consider a company unlikely to develop a healthy risk management culture.

Remaining True To The Core Business

In the Middle East, real estate makes up a significant proportion of many insurers' investment portfolios. We have seen many boards use local knowledge to generate sizable gains on their investment initiatives, particularly when markets are buoyant. But in some cases, we have had to question whether we are looking at an insurer that also develops real estate, or at a property developer that also underwrites some insurance.

We have also seen the competing concerns of management outweigh considerations of risk. For example, the strict pursuit of complying with Islamic Sharia law can lead management to favor compliant, but higher-risk equity and real estate investment strategies over noncompliant, but lower-risk and more-liquid bond- or cash-orientated assets, which may be better-matched to the liability profile of the insurer.

For regional reinsurers, diversification of risk is paramount, but should be carefully considered. The search for diversification can push companies into new markets and new lines of business, where mistakes and surprises are more likely to occur. Just because a reinsurer can successfully write motor liability or property risk in Russia does not guarantee success if it diversifies into writing apparently similar risks in Kazakhstan or Turkey. Similarly, many years of reasonably stable performance writing business on a proportional basis may still not qualify a reinsurer to price and write similar lines on a facultative basis.

Circumstances that seem benign can bring threats as well as opportunities. A credit rating upgrade may enable a company to access business from which it was previously excluded. If it does not fully understand the new sectors into which it is venturing, it may overexpose itself in ways it fails to predict. Diversification of risks may reduce correlations between the various lines of business written, but if the new risks are not adequately analyzed and priced, then the diversification may succeed only in further increasing the company's overall risk exposure.

Building Strong ERM Foundations

In our view, not every insurer or reinsurer needs world-class ERM. For example, a smaller company writing largely predictable risks in a stable market may only need to meet its regulator's requirement to offer transparent corporate governance, efficient risk management, and an effective internal audit function. However, as their companies grow in size and complexity, emerging market insurers and reinsurers need to effectively manage the transition between traditional and more advanced forms of risk management. Some periodic assistance may be sought from external specialists, but we consider it highly desirable that the risk management process not be delegated to third-party consultants. It is essential that the company retain full "ownership" of its evolving risk management improvement process.

Where prudential risk controls are in place and a proper sense of risk awareness permeates the entire organization--top to bottom--an insurer or reinsurer has the foundations for a properly functioning ERM framework. Embedding a proper risk management culture across the whole organization while maintaining appropriate risk controls will always, in our view, remain the essential first steps to the creation of an at least adequate ERM framework.

DUBAI ISLAMIC INSURANCE & REINSURANCE (AMAN) RATINGS AFFIRMED AT 'BBB-' AFTER INSURANCE CRITERIA CHANGE; OUTLOOK STABLE

Published: June 27, 2013

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OVERVIEW

- Following a review of Dubai-based Dubai Islamic Insurance & Reinsurance Co. (Aman) under our revised insurance criteria, we are affirming our 'BBB-' ratings on the company.
- The ratings predominantly reflect our view of the company's satisfactory business profile and less than adequate financial risk profile. These assessments are underpinned by Aman's adequate competitive position in the United Arab Emirates and its moderately strong capital and earnings, as well as a less than adequate financial flexibility, and a high risk position.
- The stable outlook reflects our view that the company's business risk profile and its capital and earnings will remain largely unchanged over the next two years.

Rating Action

On June 27, 2013, Standard & Poor's Ratings Services affirmed its 'BBB-' insurer financial strength and counterparty credit ratings on Dubai-based Dubai Islamic Insurance & Reinsurance Co. (Aman). The outlook is stable.

Rationale

The ratings reflect our view of the company's satisfactory business risk profile, which is partly offset by a less than adequate financial risk profile. These outcomes reflect our intermediate assessment of country and industry risk for insurers operating in the United Arab Emirates (UAE), as well as Aman's adequate competitive position, moderately strong capital and earnings, less than adequate financial flexibility, and high risk position. We base our assessment of Aman's risk position on its equity-oriented investmentstrategies, which have resulted in latent unrealized losses, and concentration risk relating to exposure to the regional banking sector. We combine all these factors to derive a 'bbb-' anchor for Aman. We assess enterprise risk management (ERM) and management and governance as neutral for the ratings; therefore the final ratings are at the same level as the anchor.

Overall, we consider that Aman faces intermediate industry and country risk. This is because its core business is largely exposed to the UAE, particularly Dubai. Our assessment is based on our view of lowinsurance product risk and intermediate country risk in the UAE. Aman's financial risk profile could potentially come under increased pressure because of the inherent credit and market risks arising from its investment portfolio. We see additional sources of risk owing to concentration risk, stemming from asset classes and market exposures in its portfolio.

Aman's competitive position is adequate, in our view. As one of the early pioneers of takaful insurance in the UAE, Aman has leveraged its many relationships with banks and brokers to reach a viable size. It offers life and non-life insurance, with both segments contributing equally to total premiums. However, although Aman's business model allows it to underwrite a diverse range of risks, the company cedes more than two-thirds of its premiums to international reinsurers. This leaves its residual net exposure concentrated in UAE motor risk, which is possibly the most competitive area in the market. In the context of a highly competitive underwriting environment, often with low tariffs, we assume in our base case that the group will report top-line growth of only 2%-3% during 2013-2015 across both life and non-life sectors.

Aman reports moderately strong capital and earnings, which we anticipate will continue under our base-case scenario despite considerable inherent market risk in its investment portfolio. Capital adequacy remains susceptible to investment losses owing to Aman's exposure to equity and property markets, as well as its sizable participations in affiliates abroad. At year-end 2012, shareholders' funds of UAE dirham (AED) 261.7 million were reduced to AED147 million owing to an accumulated AED99.3 million of unrealized losses, mostly arising from listed securities.

We estimate Aman's operating profit to be AED7 million-AED8.5 million annually or 2013-2015. This should translate into overall net income of AED5 million-AED7 million each year over the same period, compared with AED2 million on average during the past five years. We expect Aman's net combined (loss and expense) ratio after reinsurance recoveries to be around 100% for the year ending 2013, and to gradually improve to 98% in 2014-2015 owing to relatively reduced expenses and better overall underwriting performance as management becomes more selective in the business it writes. Highly reinsured lines will likely exhibit stable earnings contribution in the form of inward commissions from reinsurers, while income from life business should gradually improve, in our view. Overall, we expect only moderate growth in premium contributions received owing to continuing competitive pressures in the somewhat overcrowded UAE insurance sector.

In our view, Aman's risk position reflects high risks, stemming from concentration and market risks in its investment portfolio. About one-half of its investments comprise equities, and approximately a further one-third of its exposure is to undeveloped land, resulting in significant market risk. The balance of its investments is largely in cash. Aman's investment portfolio also carries a degree of sector and single-name concentration. The company's equity investments are weighted toward the banking and real estate sectors, which make up approximately 80% of the share portfolio.

We view Aman's financial flexibility as less than adequate, owing to its size and unproven ongoing sources of funding. Furthermore, low profitability at Aman constrains its capacity to service both existing, and any incremental, debt.

We regard Aman's adequate ERM and fair management and governance practices as neutral for the rating. Our assessment of ERM reflects our view that risk controls are adequate overall, but that economic capital modeling and strategic and emerging risk management are weak.

Aman's management and governance is fair, in our opinion. The board of directors, which includes influential local businessmen, exerts ultimate control over the company's strategy, while a small and experienced executive management team is responsible for operations. The company's governance also relies on an internal audit committee and investment committee.

We consider Aman's liquidity as strong, owing to the 15% cash it holds in its investment portfolio, with a further 50% in marketable equities. However, we believe that unlisted equities that account for about 20% of the investment portfolio may not exhibit appropriate liquidity under a stress scenario.

Outlook

The stable outlook reflects our view that Aman's business risk profile and its capital and earnings will remain largely unchanged in the next two-to-three years.

We are unlikely to raise the ratings in the next 12-24 months as we believe that Aman's less than adequate financial risk profile will only improve gradually at best. That said, we could consider raising the ratings if we see greater diversification and a reduction of market risk in Aman's investment portfolio, leading to a more moderate risk position.

We could consider lowering the ratings if Aman fails to maintain its current competitive position, or if capital and earnings fall significantly below our current base-case expectations with little likelihood of rapid recovery.

COMPETITION AND OVERCAPACITY ARE HARMING THE UAE TAKAFUL SECTOR

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DUBAI (Standard & Poor's) July 3, 2013--Despite rising contributions (premiums), which Standard & Poor's Ratings Services estimates grew at over 15% in 2012, in our opinion the UAE takaful sector is not performing effectively for either the fund members, through generation of reliable fund surpluses for distribution, or shareholders, through generation of profits. We see that overall, takaful fund deficits are increasing, at least in the United Arab Emirates (UAE) and Kuwait, thereby eroding capital strength and ultimately weakening the sector's financial strength.

The continuing weak performance of the takaful insurance sector, particularly in UAE and Kuwait, cast a shadow over proceedings at the World Takaful Conference held in Dubai earlier this year. As an indicator, we note that no listed UAE takaful company has accumulated a distributable surplus for takaful fund members. In the first quarter of 2013, we note that the takaful fund deficits in UAE rose by over 70% from Dec. 31, 2012, and that in 2012, those same companies saw their fund deficits increase by almost 40% from Dec. 31, 2011. Excluding new capital introduced to the sector in 2012, UAE takaful companies recorded zero growth in shareholder funds, after providing for the deficits in takaful funds, which the shareholders covered through qard hassan facilities. This is in marked contrast to the UAE conventional insurance sector, where total shareholder funds grew by 5% in 2012 (before any new capital injections), with a smaller growth in premiums.

A Question Of Competition

Why is the takaful sector underperforming? The key reason, in our view, is that it must compete directly with conventional insurance companies that benefit from established economies of scale, have longer service track records, and have more established distribution mechanisms to the marketplace--on balance the conventional insurance sector companies are less intermediary-dependent for their revenue streams. It would also seem that there is no meaningful uninsured Islamic community that the takaful sector can rely upon to provide business stream--it is already serviced by the conventional sector.

We also share the opinion of many that the Gulf Cooperation Council (GCC) insurance markets are now overpopulated with insurers. This is giving rise to overcapacity with the predictable, and expected, response of price competition in the insurance market. Insurance companies require considerable capital investment to become established, and new, usually small, companies are under pressure to deliver healthy returns to their investors. In the short-tail lines of motor and medical insurance that predominate in GCC markets, under-pricing will become evident very quickly and we believe this is in part evidenced by the poor technical results of the takaful sector.

We estimate that in 2012, the takaful combined ratio (loss ratio plus wakala fee expense ratio) in the UAE rose to 115% from 109% in 2011. In the first quarter of 2013, this deteriorated markedly to 143%. Net claims costs are not so out of line with the market norms as represented by the conventional sector. What we see as significant, therefore, is that the level of wakala fees charged on the takaful funds have risen from 13% of gross contributions in 2011 to 18% in 2012, and 22% in the first quarter of 2013.

(**Important Note:** these statistics exclude the published results of Islamic Arab Insurance Company/Salama).

At first sight, these percentage increases in the wakala fee ratio may appear insignificant. But when we look at the wakala fee as a percentage of net contributions earned, the disparity is more marked. At the end of 2012, wakala fees rose to 54% of net contributions earned from 33% in 2011. And in the first quarter of 2013, wakala fees were 66% of net contributions earned. The comparator to this is the level of general expenses borne by the fund operators (the shareholders) as a percentage of net contributions earned, and in the first quarter of 2013 this was 43%, compared to the 2012 level of 53% and 43% in 2011. So, we see an increasing margin being demanded by the operator from the takaful fund members. In 2011, the operators were effectively subsidising the takaful funds, but this is not so in 2013.

The takaful model as commonly used in the GCC, is a sharing of risks among the fund members, in contrast to the transfer of risk in the conventional model. As a result, therefore, the underpricing of risks, as evidenced by increasing deficits on takaful funds can only be recovered through higher contributions--effectively higher premiums--paid by fund members. Yet, based on our experience of the mutual insurance sector elsewhere in the world, it is difficult to recover past losses through supplementary calls on policyholders or raise premium rates for takaful members.

Sustainable Performance Points The Way Forward

Despite the aforementioned shortcomings, we still consider the core GCC takaful insurance model to be sound. However, the proliferation of insurance sector participants, coupled with robust competition for risks, is making it difficult for many of the takaful companies established in the past few years to deliver a sustainable level of performance. As the loss ratios being suffered are within market norms, it is the expense bases that need controlling, and to be matched to the operational scale.

On the positive side, we believe the UAE and Kuwait insurance markets could deliver relatively strong growth in new premiums in the coming years, a reflection of these states' growing economies. The challenge for takaful insurers, as for any new insurer, is to attract and sustain a well-priced volume of stable business at a scale sufficient to cover their cost bases.

Standard & Poor's Ratings Services, part of McGraw Hill Financial (NYSE: MHFI), is the world's leading provider of independent credit risk research and benchmarks. We publish more than a million credit ratings on debt issued by sovereign, municipal, corporate and financial sector entities. With over 1,400 credit analysts in 23 countries, and more than 150 years' experience of assessing credit risk, we offer a unique combination of global coverage and local insight. Our research and opinions about relative credit risk provide market participants with information and independent benchmarks that help to support the growth of transparent, liquid debt markets worldwide.

SAUDI ARABIAN INSURANCE IN THE THIRD QUARTER OF 2013: WILL THE WINNERS TAKE ALL?

Published: September 11, 2013

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Business should be booming for insurers in the Kingdom of Saudi Arabia. The scope for insurable activity is steadily growing, insurance density (premiums per capita) is improving from a low base, and premiums have grown nearly 18% a year since 2008 on a compound annualized basis. Yet, the market is plagued by underperformance and loss.

So what is going wrong?

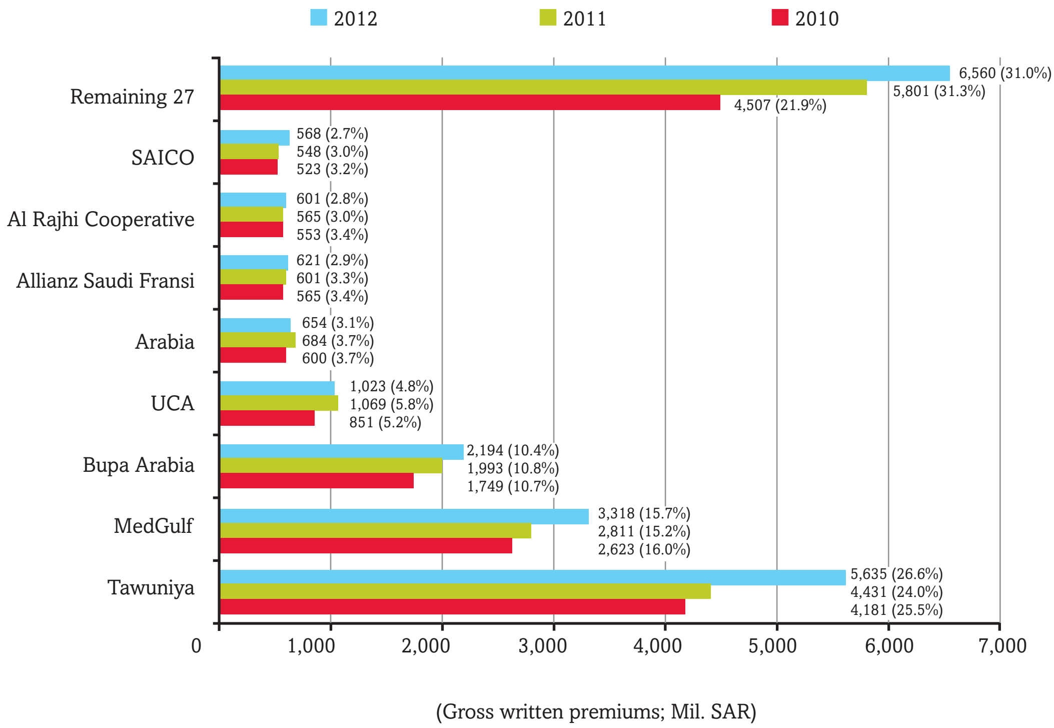
At the operating level, costs and overheads are part of the problem, and they are certainly high relative to peers in some neighboring Gulf Cooperation Council (GCC) markets. Yet we believe the issue is more fundamental: the very structure of the market (Watch the related CreditMatters TV segment titled “Quest For Profitability Continues In Saudi Arabia Insurance,” dated Sept. 20, 2013.).

It is almost too easy to suggest that at 34 in total, there are too many insurers in the KSA. The real problem is less the absolute number of players and more the high degree of market share concentration. Perhaps too much of the KSA insurance “cake” is being eaten by too few companies, leaving the crumbs for the rest. At the same time, the market leaders’ results show that they themselves--despite their undoubted competitive advantages of scale, distribution, and branding--have been propping up their market share by artificial means. In particular, their aggressive pricing policies have depressed rates to barely sustainable levels, and have distorted the economics of the whole market. However, a particular concern of many smaller local insurers today is the new pricing regime introduced by the insurance regulator for the main lines of medical and motor earlier this year.

The principal regulator, the Saudi Arabian Monetary Agency (SAMA), issued a directive stating that all KSA-based insurers must apply actuarial pricing to their motor and medical policies. In practice, the initiative risks further entrenching the competitive advantages of the largest players in a market that is already highly concentrated in the hands of its leading players (see chart 1). These larger insurers generally enjoy lower expense ratios that permit cheaper tariffs under the new pricing rules. Yet smaller players--whose expenses tend to run somewhat higher relative to revenues--are now obliged to charge higher prices than their larger peers, further undermining their viability in an already difficult market. The result risks even greater concentration of business in a sector where, in 2012, 76% of the Saudi Arabian riyal (SAR) 20.6 billion in primary insurance premiums were written by the 10 largest companies, and 54% by just the top three. These larger companies and some of their more efficient, midmarket peers may be able to function satisfactorily under the new pricing regime. Smaller insurers, though, unless they can lower their cost base, risk having to price themselves out of the market if they apply prudential, actuarial tariffs.

CHART 1

KINGDOM OF SAUDI ARABIA INSURANCE MARKET SHARES AND STRUCTURE (INCLUDING INWARDS REINSURANCE WRITTEN BY SAUDI RE)



SAR--Saudi Arabian riyal. Source: Standard & Poor's with additional data from the Saudi Arabian Monetary Agency.

How Many Is Too Many?

If 12 licensed banks are sufficient to service the Kingdom's banking needs, how many insurers does Saudi Arabia need? In our view, there is no "right" or "wrong" number, but looking back over the past three years, we have observed some half dozen or so insurers, out of 34 in total, that seem to be finding it hard to gain traction and to make sustainable profits in the current marketplace. For these entities, merger must be a serious consideration, and one that the authorities are known to be keen to promote. If outright insolvency is unacceptable, merger, ideally with a stronger peer, becomes the most realistic option. However, two or more weak companies coming together would not necessarily transform into a single strong one. Meanwhile, although some large, international insurers not already present in the KSA may opt to enter Saudi Arabia by means of an acquisition, it remains to be seen why a large, strong company already active in the Kingdom would wish to acquire a small, weak one--unless encouraged to do so by regulators with a mix of incentives and threats. As a third alternative, the KSA may wish to learn from insurers in other markets that take the "orderly run-off" approach. This involves an insurer simply closing to new business, paying off its outstanding claims to policyholders, and dissolving itself after returning its residual capital to shareholders.

The Ingredients Are There For A Thriving Insurance Sector

Despite these existential issues, the KSA nonetheless has both the economic base and the demographics to support a vibrant insurance sector. The Kingdom benefits from substantial government infrastructure spending and a large, often affluent population of 29.2 million (nearly 20

TABLE 1: GROSS WRITTEN PREMIUMS IN SAUDI ARABIA 2008-2012					
(SAR mil.)	**2008**	**2009**	**2010**	**2011**	**2012**
Motor	2,542	3,055	3,239	3,922	4,689
Health	4,805	7,292	8,690	9,708	11,285
Other P&C	2,978	3,260	3,487	3,969	4,311
Protection & Savings	594	1,003	972	905	889
Total	10,919	14,610	16,388	18,504	21,174

SAR--Saudi Arabian riyal. Source: Saudi Arabian Monetary Agency, Saudi Insurance Market Report, 2011.

million Saudi nationals plus some 9 million expatriate workers and their dependents). Insurance density remains low by developed market standards, but is improving. The SAMA Insurance Market Report for 2012 indicates SAR725 of premium per head of population (2011: SAR682), with total gross premiums written (GPW) across the sector in 2012 of SAR21.2 billion (2011: SAR18.5 billion). A second ratio that is also frequently quoted is that for insurance penetration (that is GWP divided by GDP), which in 2012 was a mere 0.78% or, perhaps more meaningfully, 1.56% of non-oil GDP.

Whatever the case, the amount that consumers spend on insurance still appears relatively low by international standards. This suggests good potential for further growth in premiums as more people and more companies require more protection for an ever greater panoply of objects and activities: from cars to apartments, health cover to professional liability, and life assurance to insurance-wrapped long-term savings, the scope for insurance products is expanding. Further support for the sector will also ultimately come with the implementation of new regulations to support the Kingdom's private home loan (mortgage) market. The assumption must be that, like other countries with a thriving mortgage sector, the KSA will see its lending mortgage banks insisting upon fire insurance for the mortgaged property, and term-life cover for the mortgage borrower. Moreover, the development of the fire (property) and life segments of the market will help address the today's imbalance whereby so much of the premium in the market relates to motor and medical (health insurance), particularly at the net level after reinsurance (see tables 1 and 2).

The Sector Is Solvent

Our analysis of company-by-company second-quarter results highlights some of the strengths and weaknesses of the sector. For example, domestic insurers wrote SAR12.5 billion of GWP in the first half of this year (up 17.6% on the SAR10.6 billion written by end-June 2012), supported by SAR9.0 billion of shareholders' funds (versus SAR8.0 billion in June 2012). In solvency terms, therefore, the market would appear to be secure with more than enough capital--on average--to support the exposure implied by premium volumes. Yet, as of end June 2013, nine insurers were below the SAR100 million level that is normally regarded as the minimum capital requirement.

TABLE 2: NET WRITTEN PREMIUMS IN SAUDI ARABIA 2008-2012					
(SAR mil.)	**2008**	**2009**	**2010**	**2011**	**2012**
Motor	2,542	3,055	3,239	3,922	4,689
Health	4,805	7,292	8,690	9,708	11,285
Other P&C	2,978	3,260	3,487	3,969	4,311
Protection & Savings	594	1,003	972	905	889
Total	10,919	14,610	16,388	18,504	21,174

SAR--Saudi Arabian riyal. Source: Saudi Arabian Monetary Agency, Saudi Insurance Market Report, 2011.

The Potential For Loss Lingers

As regards earnings, the sector as a whole turned in an overall net loss before tax of SAR93.1 million in the second quarter of 2013, after a break-even result in the first quarter. In part, this was due to a large fire loss in Jeddah in June of this year that was co-insured by many local insurers. Whatever the case, only 18 insurers declared a pretax profit in the second half, down from the 22 that reported profits in the final quarter of 2012. Overall, after total income statement and balance sheet adjustments, the second quarter saw total shareholders' funds fall by some 2%, or SAR193.6 million relative to the first quarter, with only 12 insurers experiencing an increase in net assets. Even the market leader has seen its shareholders' funds fall by 3.2% in 2013 to-date--to SAR2,074.5 million from SAR2,142.9 million--despite having written some 21.9% of the GWP generated in the KSA in the first half of 2013. That said, we must remember that in the KSA, all insurers are obliged to set aside bad and doubtful debt provisions for premiums not received within 90 days of policy inception. Consequently, some of the losses now being reported may transform into profits once the deferred premiums are actually received and the loss provisions reversed.

Many Changes Are In Store, But Size Will Remain A Potent Advantage

With over half the market--18 insurers--reporting a reduction in shareholders' equity by end June 2013, relative to end-2012, it is perhaps not surprising that the mood of much of the market is somber. This can perhaps also be seen in the number of changes in senior management across the sector as both foreign and domestic shareholders push for better results. Even at SAMA, the faces at the top are changing, and perhaps this new generation of insurance and regulatory managers will find innovative ways to reinforce the sector and improve market sentiment.

Likely changes may include a greater impetus for consolidation among smaller, loss-making players; aggressive cost reductions to help justify lower, actuarially based pricing; and maybe a concession or two from the regulators to help the sector as a whole. Such concessions may manifest themselves as reductions in the fees and taxes paid to the authorities, and on the accounting front, in a change to the regulation that requires deferred premiums to be heavily provisioned as bad and doubtful debt. Whatever happens, size combined with efficiency will remain a potent competitive advantage, and one that should see the larger companies in the KSA insurance sector steadily increasing both their earnings and market shares. These insurers--a number of whom we rate--are likely to see their financial strength stabilize or even improve as the enforcement of actuarial pricing locks what should be decent profit margins into the business they will be writing in the second half of the year. This will leave the smaller, loss-making, and usually unrated players under an increasing obligation to consider their diminishing list of strategic options.

SAUDI ELECTRICITY GLOBAL SUKUK CO. 2 TRUST CERTIFICATES ASSIGNED 'AA-' RATING

Published: March 20, 2013

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DUBAI (Standard & Poor's) March 20, 2013--Standard & Poor's Ratings Services said today that it assigned its 'AA-' issue rating to the proposed ijara trust certificates to be launched by Saudi Electricity Global SUKUK Co. 2, a special-purpose vehicle incorporated in the Cayman Islands. These certificates benefit from a purchase undertaking provided by Saudi Electric Co. (SEC; AA-/Stable/--). The purchase undertaking is designed to return principal and accrued periodic distribution payments in a timely manner and to redeem the full value of the certificates at maturity. We equalize the rating on the certificates with our long-term corporate credit rating on SEC, reflecting our expectation that the certificates will rank pari passu with the company's other unsecured obligations.

Saudi Electricity Global SUKUK Co. 2, as the issuer and trustee, will invest the proceeds of the trust certificates to purchase Sharia-compliant ijara assets from SEC, which it will subsequently leaseback to SEC. The lease payments from SEC to the issuer will be based on periodic distribution payments (a profit payment), which will cover the issuer's debt service obligations toward the certificate holders over the term of the certificates. Certificate holders have a beneficial interest in the trust that holds the ijara assets, but do not have direct recourse to those assets.

Upon maturity of the certificates or the occurrence of a dissolution event, the trustee, acting on behalf of certificate holders, is entitled to exercise a purchase undertaking requiring SEC to purchase the assets at a price covering the aggregate face amount outstanding of the certificates and accrued and unpaid periodic distribution amounts, according to the terms of the certificates.

Standard & Poor's has not evaluated whether the trust certificates are Sharia-compliant. The ratings solely represent our opinion about the likelihood of full and timely repayment of the certificates issued under the program.

The ratings on SEC reflect our view of the company's "satisfactory" business risk profile and its "significant" financial profile.

SEC's business risk benefits from the company's quasi monopoly on electricity generation and a monopoly on transmission and distribution, with minimal, if any, competition in the medium term. In addition, we factor in the strong forecast growth in electricity demand as well as ongoing government support.

These credit strengths are offset, in our view, by SEC's financial risk profile. SEC is affected by negative free cash flows linked to its significant investment program, which we expect to persist until at least 2015. Other weaknesses include regulatory risk affecting the company's three key business segments, leading to weak profitability and uncertainty relating to payables that continue to accrue on SEC's balance sheet owed to oil company Saudi Aramco.

The company expects to invest about Saudi Arabian riyal (SAR) 230 billion from 2013 to 2017, although management considers some of this capital expenditure to be discretionary. According to our base-case financial model, this will lead to deterioration in financial metrics.

RECORD LOW BORROWING COSTS ARE BOOSTING GULF ISSUERS' CREDIT QUALITY, BUT WILL THEY LAST?

Published: April 5, 2013

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Industry Credit Outlook

Corporate and infrastructure issuers in the Gulf region are benefitting from sustained positive macroeconomic fundamentals and strong appetite from regional and international investors for high credit quality paper. This, along with a liquid banking sector, is underpinning their credit profiles by allowing them to refinance and/or raise new debt in bank and capital markets at good rates. But the situation could change if borrowing costs were to revert to levels seen only two years ago. (Watch the related CreditMatters TV segment titled "How Will Record Yields For Gulf Issuers Influence Infrastructure Financing?," dated May 3, 2013.)

Gulf Cooperation Council (GCC) hydrocarbon exporters' macroeconomic fundamentals remain strong, driven by a sustained Brent oil price above $100 per barrel, leading us to expect GDP growth of 4% and above in 2013 for most of the GCC nations. The GCC region's economic performance is more in line with faster-growing emerging Asian-Pacific and African than European or North American markets. All GCC sovereigns have stable outlooks, following our revision of Bahrain's sovereign rating from negative to stable in February 2013, and the average GCC sovereign rating remains firmly in the 'A' category.

Gulf banks are recovering faster from the financial crisis than those in many developed markets. We think their financial performance will continue to improve this year on the back of favorable economic conditions and strong capitalization. We also expect the banks to continue to strengthen their business this year through acquisitions and by tapping capital markets.

These positive factors combined with a dearth of high-grade issues from the region mean that when government-related entities (GREs) have tapped the market--as with Qatar Telecom (Qtel) Q.S.C.'s $1 billion 15/30 year bond in January 2013 and Dubai Electricity and Water Authority's (DEWA) $1 billion 5-year and Saudi Electric Co.'s $2 billion 10/30-year sukuk in February and March 2013--they have been able to achieve rates that are significantly lower than only a year ago, as well as longer tenors. There are, however, signs that yields may have reached a trough, as some new issues are trading below par in the secondary market.

The key risks to this rosy picture are an escalation in regional political instability or an unexpected fall in oil prices. Fortunately, these risks are negatively correlated, with any threat to supplies of hydrocarbons normally resulting in immediate price hikes. That said, a rise in capital expenditure by GCC governments following the Arab Spring and continuing spending on much-needed infrastructure development has resulted in oil-price fiscal break evens--the oil price at which government budgets balance--rising to around $80 per barrel for Saudi Arabia, the UAE and Oman and as high as $120 per barrel in Bahrain, according to the International Monetary Fund (IMF), leaving governments with limited room for maneuver.

Another risk factor is rising inflation over the medium term as a result of a significant investment drive led by GCC power and water, transportation, and real estate development GREs. Qatar is planning to invest about $125 billion in expressways, railways, and airport and port expansion from 2011-2016, according to MEED, so like Saudi Arabia and the UAE, will have to keep inflation under control.

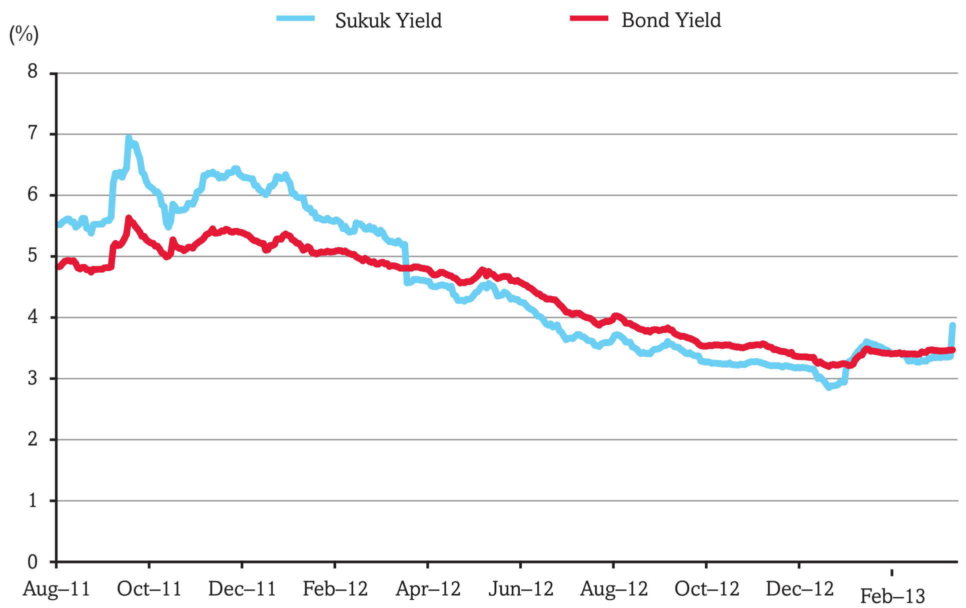
OVERVIEW

- Sustained high oil prices mean we expect GDP growth of 4% and above in 2013 for most of the GCC nations, all of which now have stable outlooks.
- Government-related entities tapped capital markets at historically low rates during Q1 2013, but capital market issuance yields may have reached a trough in early 2013.
- High expenditure, political risk, lack of diversity, and potential rising inflation remain key challenges for GCC nations and their government-related entities.
- GCC capital market issues are steady, with sukuk contributing over a third of volumes.

Low Yields Push GCC Issuers Toward Capital Market Issuance

A strong Q4 2012 and somewhat weaker Q1 2013 have resulted in marginally higher issuance volume of US$31.2 billion over the past six months compared with $31.0 billion over the same period one year

CHART 1
HSBC NASDAQ DUBAI GCC CORPORATE U.S. DOLLAR BOND AND SUKUK INDICES



Source: HSBC NASDAQ Dubai.

ago, according to data from Zawya. Similarly, sukuk issuance increased slightly to $11.2 billion from USD11.0 billion, accounting for just over a third of total issuance volumes.

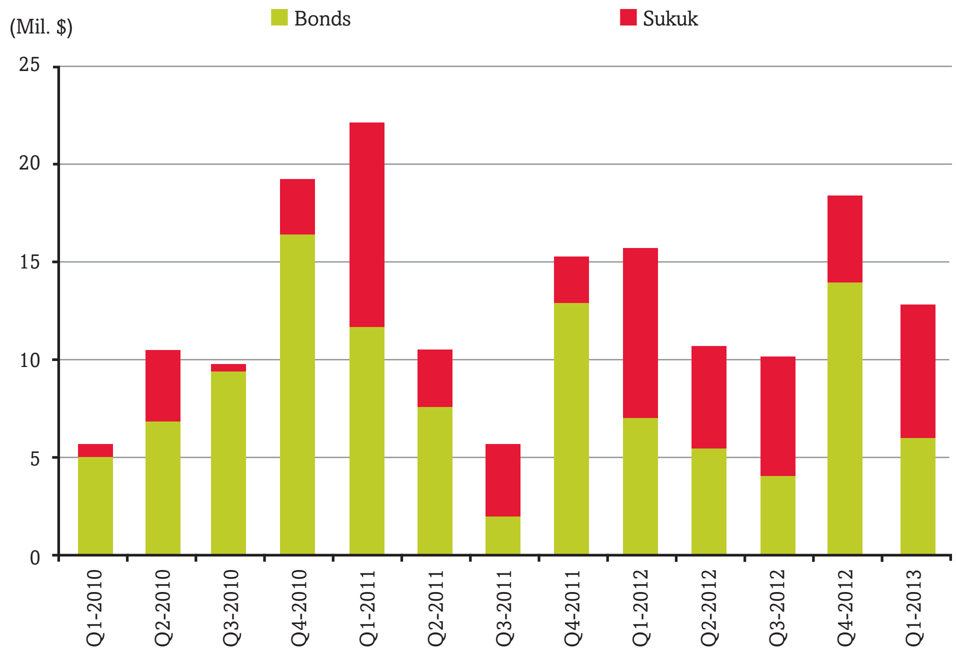
Sukuk issuers in 2013 included rated companies DEWA, and Saudi Electric Co. Increasing use of the U.S. dollar as the currency of issuance is an interesting trend. This was DEWA's first U.S. dollar sukuk. Increasingly, rather than establishing multi-billion U.S. dollar medium term notes programs, many GCC issuers are opting for the RegS route with bespoke issuance in the Islamic market.

Yields have continued to contract over the past six months, hitting record lows at the beginning of Q1 2013. This was the culmination of an unprecedented drop in yields of over 30% since the beginning of 2012. The longstanding premium for GCC issuers over peers in developed markets has truly vanished. This is especially true for Dubai-based issuers, where the economy is performing well, driven by strong trade, tourism, and logistics sectors, recovery in the real estate market, and further progress on debt restructurings at, for example, Dubai Group and Gulf General Investment Company. We believe all of these factors should make negotiations on the refinancing of Dubai GREs' debt falling due in 2013 and 2014 much easier.

We have noticed a small uptick in yields in Q1 2013, suggesting we may now have reach the trough. The lackluster performances of some new issuances in the secondary market, such as the Dubai government's 10/30year $1.25 million sukuk issued in January 2013, also point in this direction.

CHART 2

GCC CAPITAL MARKET ISSUANCE



Source: Zawya.

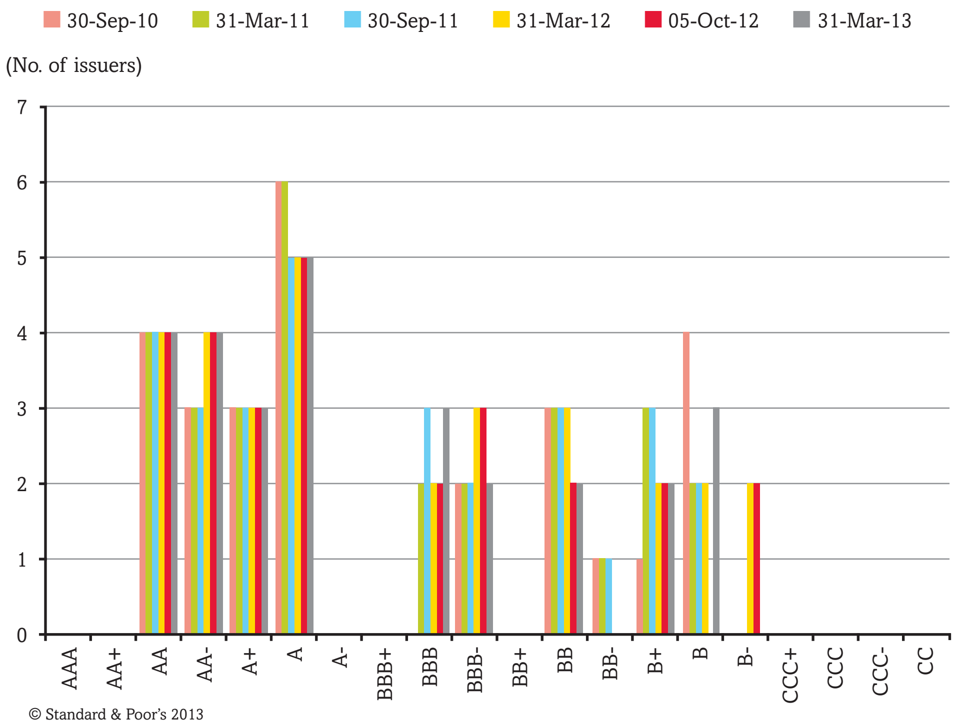
Positive Rating Actions Predominate

We took seven rating actions over the past six months--six of positive and one negative. The positive actions included an upgrade of DEWA to 'BBB' from 'BBB-' on robust financial results and managed plans to raise money in the capital markets to meet mid 2013 debt maturities. We revised our outlook on Ajman Sewerage (Private) Co. Ltd. to positive from stable following the successful completion of enhancement works. We also upgraded MB Holding Co. LLC to 'B' from 'B-' on strengthened liquidity and improved operating cash generation, and we revised the outlooks on Bahrain Mumtalakat Holding Co. and Bahrain Telecommunications Company (Batelco) to stable from negative in line with our rating action on the sovereign.

Of the 28 issuers that we rate in the GCC corporate and infrastructure segment, 25 have stable outlooks, two have positive outlooks, and one has a negative outlook. The only issuer with a negative outlook is Qatar Telecom, reflecting increased country risk and financial leverage following acquisitions outside its home market. Aldar Properties has a positive outlook on the promise of a strengthened credit profile after its proposed merger with lower-leveraged Sorouh Real Estate PJSC. positive outlook

CHART 3

GCC CORPORATE AND INFRASTRUCTURE RATINGS DISTRIBUTION



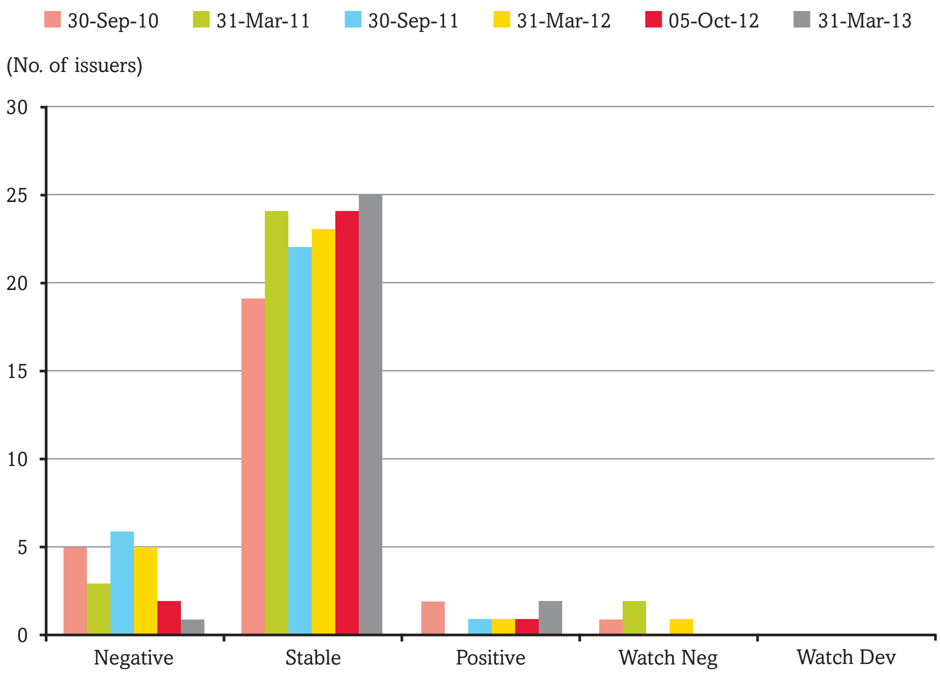
on Ajman Sewerage reflects the completion of enhancements under its treatment plant enhancement works contract and an updated assessment of the project's financial profile.

Residential real estate markets stabilizing, but the office segment remains weak

We think demand for office space will continue to lag supply in most GCC markets, and the situation could worsen once projects that are currently being developed are delivered. Oversupply is affecting the region's major capital cities, with vacancy rates of 15% or higher.

The performance of residential property markets across the region has varied depending on location, although most GCC markets are stabilizing after four years of significant declines. The Dubai residential segment has strengthened significantly in more established locations. The Saudi government's sizable stimulus measures and new mortgage law will likely continue to underpin demand for residential real

CHART 4
GCC CORPORATE AND INFRASTRUCTURE OUTLOOK/ CREDITWATCH DISTRIBUTION



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estate and land, in our view. That said, it is hard to see prices rising significantly from current levels given the very significant number of buildings under construction in places like Dubai, Abu Dhabi, Doha, and Muscat, apart from select sought-after areas and developments where supply is limited.

Meanwhile, we anticipate that the GCC retail property market will be driven more by supply than demand over the next two to three years. In Dubai, where additional supply remains limited, prime rents have risen. Rents have been stable in other major markets such as Abu Dhabi and Doha, although significant new development pipelines will likely put these to the test.

This year started on a very positive note for the hospitality industry with significant increases in revenue per available room (RevPAR) across the region, led by Dubai. This is despite significant supply additions in the major cities like Riyadh, Dubai, and Abu Dhabi. There are large pipelines for new developments, however, especially in Riyadh, Jeddah, Muscat, and Abu Dhabi, which may put pressure on or prevent further recovery in occupancy levels and average daily rates (ADRs).

Telecom operators' performances broadly in line with expectations
The performances of our rated GCC-based telecoms operators remain broadly in line with our expectations. While former incumbent operators continue to lose market share due to intensifying competition, growth in their broadband businesses--both fixed-line and mobile--should shield them from significant revenue loss. At the same time, falling prices continue to constrain profitability, although margins remain higher than those of peers in mature Western European markets. The only exception is Batelco, which continues to suffer revenue decline and margin erosion because of competition that we have already factored into our assessment of the company's business risk profile.

Telecoms operators' international operations are expanding as operators target revenue and EBITDA diversification. That said, country risk in the region is also on the rise, which could weaken our assessments of operators' business risk profiles in the coming years.

Most of the GCC-based telecoms operators that we rate--such as Emirates Telecommunications Corp. (Etisalat) and Saudi Telecom Co.--maintain solid balance sheets with low debt-to-EBITDA ratios at the parent company level. This should provide flexibility for potential merger and acquisition activity. Qatar Telecom is more highly leveraged than its regional peers and continues to be acquisitive, which increases its exposure to country risk and higher leverage. This is why we revised our outlook on Qatar Telecom to negative from stable.

Utilities' robust performances exceed expectations, as they turn increasingly to Islamic finance to fund capital expenditure needs

DEWA and Saudi Electric Co. reported strong 2012 results because of strong demand for power and water in both markets, population growth, and the limited levels of competition across their vertically integrated power and water models. Both entities opted not to put a permanent funding solution for their medium and long term debt maturities in place, but rather to arrange capital market issuances on a bespoke basis, typically in the form of sukuk issued in dollars targeting the regional and international markets. Both entities have been successful to date in issuing at compellingly low prices, to a large extent because of their sovereign ownership, but also due to their robust underlying performance.

Abu Dhabi National Energy Co. PJSC (TAQA) performed well in the power and water segment in 2012, although the segment of its business that is exposed to oil and gas exploration and production activities impaired net profits.

DEWA, Saudi Electric CO., and TAQA all face important debt maturities over the next few years, however. We currently believe that they should be able to meet these maturities, in line with our assessment of their liquidity as "adequate, as our criteria define the term.

The absence of cost-reflective tariffs continues to constrain the stand-alone business risk profiles of many rated GCC utilities, with the exception of Oman Power and Water Procurement Co. SAOC, which we view as operating under a benign and well-administered cost-reflective mechanism only used by Oman for this particular issuer.

Robust oil prices bode well for project finance, while players are increasingly tapping capital markets and private sector partnerships

We believe robust oil prices will remain sustainable throughout the rest of the year and into 2014 (See "Standard & Poor's Revises Its Oil And Natural Gas Liquids Price Assumptions; Natural Gas Price Assumptions Remain Unchanged," published on Feb. 11, 2013 on RatingsDirect). High oil prices are likely to continue to benefit the Ras Laffan Liquefied Natural Gas Co. Ltd., Ras Laffan Liquefied Natural Gas Co. Ltd. (II), and Ras Laffan Liquefied Natural Gas Co. Ltd. (3) projects (together, RasGas) because liquefied natural gas (LNG) sale contract terms have about 60% of their contracts indexed to crude oil prices. That said, LNG producers including RasGas, and suppliers of gas through pipeline delivery such as Gazprom, are finding some resistance in European markets to the price formulation of existing oil based pricing of LNG contracts. (See "FAQ: Do Recent Rulings Herald The Divorce Of Oil And Natural Gas Prices, And Who Will Benefit?" published Feb. 4, 2013). In the current context of high oil prices and oversupply of gas in the European market, oil-indexed gas import prices have been well above European spot prices and parity levels for alternative fuels such as coal. With oil-indexed import contracts permanently "out of the money" importers have been forced to incur losses in their trading segments to be able to place contracted import volumes in the marketplace. This has pushed Central and Western European importers to file arbitration cases and/or renegotiate long-term supply contracts with the likes of RasGas and Gazprom.

In RasGas' case we take comfort from the fact that deliveries continue to all three European offtakers--Edison, Endesa, and Distrigas--with which it is currently in arbitration, and that these three offtakers combined represented less than 20% of RasGas' total cargo sales in 2012. Furthermore, RasGas' strong financial results in 2012 show that despite these disputes, the project continues to operate in a market with strong demand for its product, and remains in a healthy financial condition from a credit perspective.

Regulatory challenges affecting the Gulf project finance market include the implementation of Basel III, which could have a direct effect on the pricing of long-term project financing, as well as the reduced involvement of European financial institutions in long-term lending to the region. What we typically see today are key GRE utility sponsors in the GCC borrowing by turning increasingly to the capital markets, and particularly sukuk, to onlend to project finance subsidiaries and fill the gap left by the banks' diminished role in the region. We think capital markets, and possibly sukuk bonds, may increasingly be used as a direct funding tool for project finance in the GCC. This trend has already started, with the first ever green-field project sukuk bond issued this year by Saudi Aramco Total refining and Petrochemical Company LLC (SATORP). While a large difference in pricing between bank and capital market finance remains for certain key government-linked issuers, we think this gap may close as long-term bank financing becomes less readily available.

Buoyant commodity prices continue to help transport entities and corporate securitizations as the sector turns increasingly to Islamic finance
Qatar-based Nakilat Inc.'s LNG shipping vessel financing transaction should continue to benefit indirectly from healthy commodity prices. In our view, this will in turn improve the financial health of the key take-or-pay charterers under the transaction, including RasGas. Still, we consider ratings upside on Nakilat to be limited, given the extremely high likelihood of timely and sufficient extraordinary support from the Qatari government for the company that we already factor into its long-term corporate credit and debt ratings.

DP World Ltd (not rated) reported gross container volume growth of 2% in 2012 to 56 million units and net profit growth of 21%. The resilience in the company's performance reflects in part that the Middle East remains its main trading hub, but also its exposure to emerging markets.

We also believe that GCC transportation companies could tap the sukuk market to fund important developments in the field--such as the Abu Dhabi Port and Qatar's rail infrastructure--following the lead of Saudi Civil Aviation's Saudi Arabian riyal (SAR)15 billion ($4 billion) sukuk that partly funded the Jeddah airport expansion.

Emirate Airlines listed a $1 billion sukuk on the Dubai Nasdaq on March 12, 2012, to buy airplanes. This support's the Dubai Ruler's pledge earlier this year to turn Dubai into the leading Islamic hub worldwide.

These transactions demonstrate the capital markets' important role in offsetting the significant transport funding challenges in the GCC region, and in particular the sukuk's flexibility.

High prices support GCC commodities players
Despite current global economic uncertainties and eurozone (European Economic and Monetary Union) recession, GCC commodities players are operating under favorable conditions. High oil prices and access to competitively priced gas mean that Middle Eastern ethylene and petrochemical producers, like Saudi Basic Industries Corp. (SABIC), retain a large competitive advantage over naphtha-based crackers in Europe and Asia. We note, however, that the shale gas boom in the U.S. and the resulting lower position of the U.S. petrochemical industry on the cost curve has significantly changed the competitive landscape in ethane production. There are several new ethane crackers planned in the U.S., while additional gas allocation in Saudi Arabia remains limited in our view.

In addition, fertilizer producers, like Qatar Fertiliser Company (Q.S.C.C) (Qafco) continue to benefit from high fertilizer prices. Fundamentally, though, elevated food prices continue to underpin these players' performances.

A key risk factor over the medium to long term is the need to phasing out energy subsidies in the Middle East and North Africa, which the IMF estimates are worth at $240 billion. Although this is not as pressing for oil exporting countries as oil importers, there is still a need for coordinated reform. This will likely result in higher feedstock costs over the medium to long term for private and government sponsored commodities producers in the region.

We think demand growth will lag supply increases for global crude distillation capacity for most of 2012-2016. Substantial capacity increases are planned in the Middle East. We think this will place increased pressure on the European refineries' already low profitability. In particular, several new refinery projects, such as those in Yanbu and Jubail in Saudi Arabia, are targeting the export market and include a high proportion of diesel output. Part of this diesel fuel will likely end up in Europe, assuming that the sizable refinery additions planned in East Asia--notably China--will satisfy much of the demand growth there. The new Middle Eastern refineries under construction are likely to be more complex, with better cost advantages than most European refineries, and their profitability should be significantly more resilient than that of those in Europe because of their lighter product output and ability to capture higher discounts on heavier and sour crude slates. We believe European refineries will find it increasingly difficult to compete. (See "What Does The Future Hold For European Oil Refiners?" published Sept. 24, 2012).

GCC sovereign ratings remain stable and buoyed by hydrocarbon resources

Sovereign ratings in the GCC are high compared with global peers', ranging from 'AA' to 'BBB'. Ratings have remained stable in 2012. Following the revision of the Kingdom of Bahrain's sovereign rating outlook to stable from negative in January 2013, all rated sovereigns in the GCC now have stable outlooks and we therefore expect the ratings to remain stable in 2013.

Economic growth, public finances, and external balance sheets in much of the GCC continue to benefit from the region's significant, though unevenly distributed, hydrocarbon resources. Average annual oil prices remained historically high throughout 2012 and have maintained high levels in 2013. The resulting inflow of funds into these economies and government coffers continues to support strong government spending, not least on a wide range of infrastructure projects in transportation, education, health, housing, industrial projects, and others. The Emirate of Dubai's (not rated) economy is also on an upward trend. While it doesn't benefit directly from a significant hydrocarbon resources, it has a diversified economy compared with other countries in the region, with well-developed transport and logistics, hospitability, and trade sectors. This diversity allows the emirate to benefit from global demand for the services it provides, and also from raised incomes in neighboring economies.

Underdeveloped political and institutional frameworks and limited monetary policy flexibility remain key ratings constraints for GCC sovereigns. There are still specific shortcomings in the effectiveness and predictability of policymaking in the GCC. Weaknesses include the quality of policy debate, the strength and depth of institutions, transparency of decision-making, data monitoring and reliability of information, legal frameworks and the rule of law, and succession risks. These partly reflect the GCC nation states' relatively short histories and their governments' roles as wealth distributors, creating less urgency for institutional depth. While GCC sovereigns are addressing some aspects of these shortcomings, reform is gradual and no GCC sovereign has attempted significant reform in the past two years.

Fixed exchange rate regimes, the lack of independent monetary policy, and shallow domestic bond markets constrain the scope for and transmission of monetary policy. While efforts to develop and deepen domestic bond markets are underway, in Qatar for example, we do not expect monetary policy frameworks and flexibility to change significantly.

We revised our outlook on Bahrain to stable from negative on Jan, 28. 2013. The outlook revision reflected our view of Bahrain's stable growth, our expectation of no further deterioration in its political environment, and the inflow of GCC development funds.

TABLE 1: GCC SOVEREIGNS THAT STANDARD & POOR'S RATES

Rating as of March 31, 2013	Foreign currency long- and short-term ratings and outlook
Abu Dhabi (Emirate of)	AA/Stable/A-1+
Bahrain (Kingdom of)	BBB/Stable/A-2
Kuwait (State of)	AA/Stable/A-1+
Oman (Sultanate of)	A/Stable/A-1
Qatar (State of)	AA/Stable/A-1+
Ras Al Khaimah (Emirate of)	A/Stable/A-1
Saudi Arabia (Kingdom of)	AA-/Stable/A-1+

ABU DHABI-BASED ALDAR PROPERTIES
PROPOSED SENIOR UNSECURED SUKUK CERTIFICATES ASSIGNED 'BB' ISSUE RATING

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OVERVIEW

- Abu Dhabi-based Aldar Properties PJSC has announced that it plans to issue senior unsecured sukuk certificates through a special purpose vehicle.
- We are rating this debt 'BB' with a recovery rating of '3'.

DUBAI (Standard & Poor's) Nov. 20, 2013--Standard & Poor's Ratings Services said today that it had assigned its 'BB' issue rating and '3' recovery rating to the proposed senior unsecured sukuk certificates to be issued by Abu Dhabi-based Aldar Properties PJSC (BB/Stable/B) through special purpose vehicle Sukuk Funding (No.3) Ltd. At the same time, we affirmed our issue ratings and recovery ratings on the existing $1.25 billion unsecured notes issued by special purpose vehicle Atlantic Finance Ltd., at 'BB' and '3'. We equalize the issue rating on the certificates with the long-term rating on Aldar Properties, reflecting our expectation that the obligations under the purchase undertaking will rank pari passu with the company's other unsecured obligations.

Our assignment of a recovery rating of '3' to the proposed sukuk certificates reflects our view of "meaningful" recovery expectations in the 50%-70% range in the event of a payment default. The recovery ratings are supported by the large valuable asset base. However, the ratings are constrained by our view of the volatility of the asset value, the unsecured nature of the instruments, the somewhat complex capital structure, the fairly unfavorable insolvency regime, and the possibility that the company could raise additional secured debt on the path to default, subject to debt incurrence and negative pledge covenants.

Standard & Poor's has reviewed its ratings on Aldar Properties, which it labeled as "under criteria observation" (UCO) after the publishing of its revised corporate criteria on Nov. 19, 2013. Standard & Poor's expedited the review of its ratings on Aldar Properties because of the company's plans to issue the proposed sukuk (see "How Standard & Poor's Plans To Finalize--And Apply--Its Corporate Ratings Criteria," published Nov. 13, 2013). With our criteria review of Aldar Properties complete, we have confirmed that our ratings on this issuer are unaffected by the criteria changes.

The sukuk is intended to partially refinance the upcoming maturity of $1.25 billion 10.75% senior unsecured notes due May 2014. Sukuk Funding will use the proceeds to buy a right ("musataha interest") to use and develop land owned by Aldar Properties, thus acting as a trustee for the sukuk holders. Sukuk Funding will then lease the land to Aldar for a five-year period--the potential tenor of the sukuk--and the lease payments will equal the periodic distribution amount on the sukuk.

For the purpose of our analysis, we have treated the sukuk as ranking equally with other unsecured debt facilities, including the $1.25 billion notes, of the group on enforcement. The assumption that the sukuk holders will rank equally with other unsecured creditors at default relies on the terms of the purchase undertaking and the fact that the sukuk holders have no ownership rights over the land assets servicing the periodic payments, but only the right to use the assets and to benefit from the lease payments. We thus assume that the sukuk holders would not have a direct claim over the underlying assets, which have not been segregated from the other group's assets.

The documentation for the sukuk includes some restrictions on the borrower and the issuer, including limitations on additional debt subject to incurrence covenants of EBITDA to consolidated net finance charges of more than 2.5x and financial indebtedness to total asset value of no more than 60%, and some limits on Sukuk Funding's activities. The incurrence covenants fall away on achievement of an investment-grade rating by any one rating agency.

Our simulated default scenario projects a payment default in 2018, mainly driven by a weakening of the general economic environment leading to reduced free cash flow generation and an inability to refinance maturing debt. Our valuation assumptions include stresses at various levels on our estimates for the book value of Aldar's assets at year-end 2017.

Importantly, we view recovery prospects as volatile since assets mostly comprise real estate, whose value depends to a large extent on economic conditions. The government also has a track record of intervening to acquire assets of national importance.

SUKUK ISSUANCE IN THE CORPORATE AND INFRASTRUCTURE SECTOR SHOULD REMAIN SOLID IN 2014

Published: November 27, 2013

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Standard & Poor's Ratings Services believes that demand for sukuk by corporate and infrastructure issuers in the Gulf is likely to continue growing at a double-digit pace in the year or two ahead, despite weakness globally in the past year. Issuance in the Gulf Cooperation Council (GCC or Gulf) grew a solid 11% in the year to Sept. 24, 2013, to reach US$14.8 billion. By contrast, volumes decreased about 25% in the period in the world's biggest country of issuance, Malaysia, dulling global performance. Prospects for that country next year largely depend on the direction of interest rates, but we foresee at least stable volumes.

Malaysian volumes for full-year 2013 could fall short of 2012 levels, however, on the back of one of the market's slowest periods in third quarter. The first half of the year already saw a 53.5% drop in corporate issuance from first-half 2012. Yet, since the U.S. Federal Reserve Bank announced that it would delay the tapering of quantitative easing, yields dropped and we are seeing an uptick in investor interest in sukuk that companies are proposing to launch--in the GCC as well as Malaysia. In that country, government issuance accounts for about 65% of volumes, complemented by issuance from the power, utilities, manufacturing, and financial services sectors.

OVERVIEW

- Demand for sukuk by corporate and infrastructure issuers in the Gulf is likely to continue growing at a double-digit pace in the year or two ahead, and could pick up in Malaysia after a weak 2013.
- Support for the market is coming from refinancing requirements, a huge need to finance infrastructure projects, the pullback in bank lending, and supportive governments, though investor uncertainty continues to hold back even stronger growth.
- The past year featured a sukuk with record-setting tenor of 30 years, compellingly low rates on some big-name issuance, but also issuance volatility on the heels of the Fed's announcements about its tapering program.

One of the main factors that continued to support GCC corporate and sukuk issuance during the period to Sept. 24--and especially in the first half of 2013--was low yields on average, because many GCC issues are denominated in U.S. dollars and are therefore sensitive to changes in Fed policy. Other factors included some improvement in the perceived credit quality of sukuk, arising from better economic conditions and higher oil prices, the continued need for infrastructure finance, and calls by GCC governments (in particular Dubai) for greater Islamic issuance by corporate and infrastructure entities.

Sukuk were issued at compellingly low prices in the first half by infrastructure entities such as Saudi Electricity Co. (SEC) and Dubai Electricity and Water Authority (DEWA), compared to historical pricing for these entities at similar tenors. These large issuances favored denomination in U.S. dollars to attract international investors, and the SEC issue broke a record in tenor with its 30-year maturity, illustrating that the market is broadening and innovating. In the past, maturities have typically been no longer than about seven years for this asset class.

After Dubai's ruler early in the year announced plans for the emirate to be the world's eminent sukuk hub, several government-related entities went to market including DEWA.

Then in the third quarter, following the Fed's announcement of a possible tapering, issuance for GCC corporate and infrastructure sukuk began to decline, mirroring the falloff in conventional bond issuance. As a result, sukuk yields spiked more than 1 percentage point. Granted, the third quarter has seen a lull in activity in the GCC in the past couple of years due to summer and religious festivities when the markets generally tend to be less active. When the Fed indicated that it would delay tapering, yields started to tighten again, and declined by about 30 basis points to about 4.2% on average over the month to Oct. 25, according to the GCC Corporates (GSKC) HSBC Sukuk Index. Certain issuers have returned to the market (notably in Saudi Arabia) such as the General Authority for Civil Aviation (GACA), with a Saudi riyal 15.2 billion issue. Al Marai Co. also issued Islamic bonds, and others such as ACWA Power have announced plans for sukuk by the end of the year. In November, the Saudi real estate entity Dar Al Arkan tapped the market with a US$300 million, three-year issuance, and the board of the country's Capital Market Authority approved Saudi Electricity's sukuk offering, whose size the company will determine at a later time.

The drivers for sukuk in the coming years in the GCC are likely to be refinancing requirements, the vast government programs for building out the infrastructure, and tighter global and local regulation of banks that could dampen their issuance. Infrastructure plans include much-needed investment in power and water, expansion related to events like the FIFA World Cup in Qatar in 2020, and corporates aiming to diversify their sources of funding with the aim of supporting the development of Islamic finance in the region. In the tougher regulatory environment, issuers are likely to turn to alternative sources of funding in the capital markets, with corporate and infrastructure entities in the Gulf favoring sukuk.

In Asia, the Asian Development Bank projects infrastructure spending at more than $8 billion over the next 10 years. Countries like India and Indonesia have some of the largest infrastructure development plans in the region, and China plans to spend about 9% of its GDP on average for infrastructure. In the meantime, regulators in Asia are looking at how to facilitate growth of the sukuk market. Hong Kong passed an ordinance in July to create a "level playing field" for sukuk. The huge demand for finance and the growing popularity of Islamic finance as an investable asset class among fixed-income investors in Asia, we believe, is likely to improve the supply-demand dynamics of sukuk in the region.

Holding back growth of the market is continued uncertainty among investors about compliance standards for sukuk, as well as about their credit risk. These two factors have typically accounted for a price premium for corporate and infrastructure sukuk over conventional bonds. In addition, the creation of local or perhaps a regional institutional investment framework--for example, so that pension or insurance funds would invest in sukuk--would go some way, we believe, toward creating a deeper and more liquid sukuk market.

WILL AFRICAN SOVEREIGNS TURN TO ISLAMIC FINANCE TO FUND GROWTH?

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Sovereign sukuk are playing an important role in the development of Islamic financial markets. Since Standard & Poor's Ratings Services started rating these Islamic bonds in 2002, sovereign and quasi-sovereign sukuk issuance has expanded to $115 billion globally in 2012. We are also seeing a broader group of sovereign or quasi-sovereign issuers of sukuk beyond their cradle of the Islamic countries in southeast Asia and the Gulf Cooperation Council (GCC). In the past, many market participants expected that developed, non-Muslim countries such as the U.K. or France would be the next to tap the sukuk market. However, we understand that cost-benefit analysis, as well as political and legal hurdles may have prevented these countries from issuing sovereign sukuk so far. Increasingly, however, it seems that sovereign sukuk issues from Africa might now be on the radar.

OVERVIEW

- An increasing number of African countries have announced their intention to issue sukuk.
- We believe they may see Islamic bonds as a way of funding growth and diversifying fiscal funding.
- Following the Arab spring, the rising influence of Islamist parties in some countries has also put the development of Islamic finance on their governments' agendas..

African countries have been growing strongly over the past few years, and generally have huge infrastructure investment needs. So far, only very few African countries have issued domestic sovereign sukuk: according to our information, just Gambia and Sudan (both not rated) regularly issue short-term sukuk. We understand, however, that a number of African countries are considering issuing sukuk in the future, either in the domestic or in global markets. In 2012, for example, the Republic of South Africa's Treasury announced its plan to issue a debut Islamic sovereign bond. This would make South Africa the first non-Muslim country to come to the Islamic market with a sovereign issue, with the exception of the €100 million sukuk sold to the market by the German regional state of Saxony-Anhalt in the early 2000s. In Nigeria--Africa's most populous country, largest oil exporter, and second-largest economy, the Central Bank announced in 2011 its intention to issue a sovereign sukuk. Nigeria has a Muslim population of an estimated 50%. At the end of 2011, Senegal announced a plan to issue around $200 in sovereign sukuk, and in 2012 Mauritania also made public its intention also to issue sovereign sukuk. Nevertheless, none of these planned issuances has taken place to date.

In our view, the North African region could also turn to sovereign sukuk issuance in the future, either in the domestic or in the global markets. Some northern African countries are facing increasing fiscal and current account deficits (see charts 1 and 2), which may suggest their governments could look to increase and diversify their funding base, despite North Africa's existing access to conventional official and private sector financing.

What's more, following the Arab spring, Islamist parties have dominated parliamentary elections in countries such as Egypt, Morocco, and Tunisia, and this has put the development of Islamic finance on their governments' agendas. Egypt's administration has recently presented a law allowing sovereign sukuk issuance, which would help to finance the country's high fiscal deficits and also provide funding for the current account deficit. Similarly, Tunisia's 2013 budget law expects to finance the fiscal deficit partly by sukuk issuance. If Morocco were to tap the Islamic finance market, we think this could originate more from political reasons rather than fiscal funding needs.

We believe that sukuk issued by African sovereigns could address an investor base in GCC countries or at the Islamic Development Bank (ISDB), which may be looking for sharia-compliant investment opportunities. Countries in the GCC generally benefit from strong current account surpluses (see chart 3), which we believe could make them potential investors in sukuk issued in other regions. For countries with both fiscal and current account deficits, attracting foreign investors to sovereign sukuk could provide fiscal funding, as well as help to cover external financing needs and support reserve-building.

While we observe that the goals behind issuing sovereign sukuk can be manifold, first and foremost Islamic bonds can give governments access to a new investor class and so diversify sources of fiscal funding. Among potential sovereign sukuk sponsors in Africa, the highest rated is South Africa (foreign currency BBB/Negative/A-2, local currency A-/Negative/A-2), followed by Morocco (foreign currency BBB-/Negative/A-3, local currency BBB/Negative/A-2), Nigeria (BB-/Stable/B), Tunisia (BB-/Negative/B), and Senegal (B+/Negative/B).

In some cases, we believe that governments plan to issue sovereign sukuk not with a view to fiscal or external funding needs, but to establish a benchmark for the development of an Islamic finance market. Then again, they may be responding to the desires of a significantly Muslim population or aiming to become a hub for the global Islamic finance market.

We think sukuk issued by African sovereigns could be eligible for investment by the ISDB, the purpose of which is to foster economic development and social progress in member countries in accordance with Shari'ah principles. Of ISDB's 56 member countries, 22 are from Africa. We understand that ISDB, as a multilateral lending institution, considers the development of sukuk markets to be one of its goals. Indeed, governments issuing sukuk could wish to attract ISDB funding. Furthermore, the ISDB is the only 'AAA' rated sukuk issuer. We rate the $6.5 billion IDB Trust Services Ltd.'s global sukuk program, as well as its Malaysian ringgit 1 billion Tadamun Sukuk Program, which addresses the Malaysian market.

All sovereign sukuk rated by Standard & Poor's to date benefit from credit enhancement from the sponsoring government or government-related entity. This allows us to rate the sukuk on par with the rating on the sponsor. Sovereign Islamic bonds are mostly sukuk al-ijara, that is, those based on leases or rents. In contrast, those of government-owned entities, such as development banks, tend to use profit-sharing sukuk structures. Governments typically do not have activities that lend themselves to profit-sharing. We have observed that the assets underlying sovereign sukuk tend to be public real estate, such as schools, hospitals, or administrative buildings. The limited availability of such assets may appear to be a constraint for greater sovereign issuance. For instance, this is currently the subject of heated debate in Egypt: challengers of the proposed sukuk law argue the government may misappropriate public assets via sukuk assets. However, we think sovereigns might use other types of government assets, such as infrastructure, especially if the proceeds of Islamic bonds are used to help finance infrastructure construction.

Nonetheless, as the examples of South Africa, Nigeria, and Senegal demonstrate, some time may elapse between announcement and issuance of sukuk, as governments weigh up potential political and legal hurdles and the costs of issuance against the benefits and potential demand.

CHART 1
GENERAL GOVERNMENT BALANCES - NORTH AFRICA

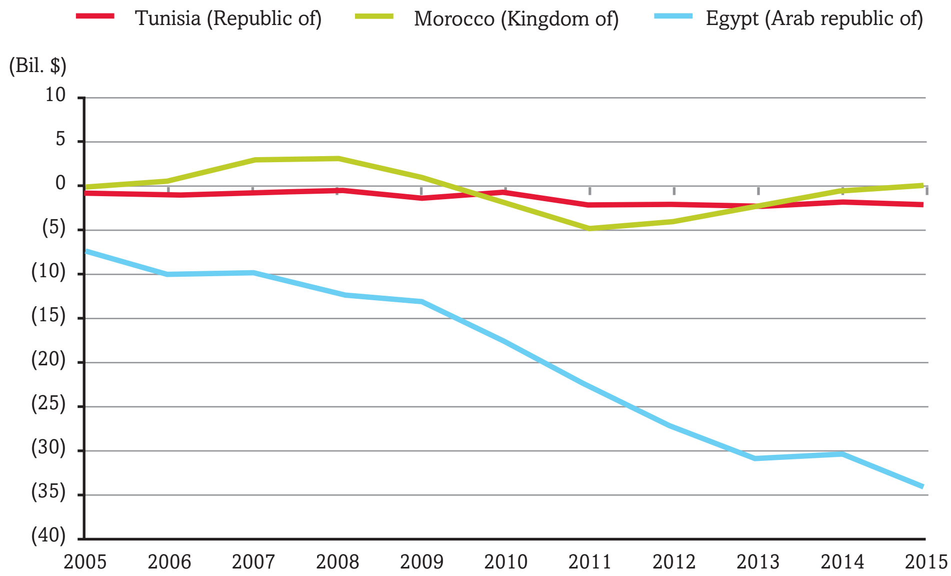


CHART 2
CURRENT ACCOUNT BALANCES - NORTH AFRICA

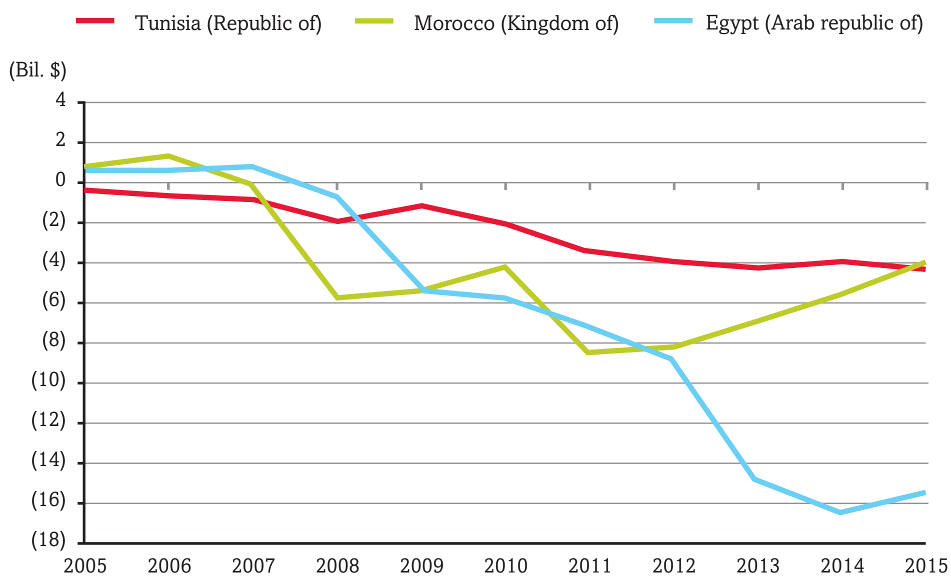
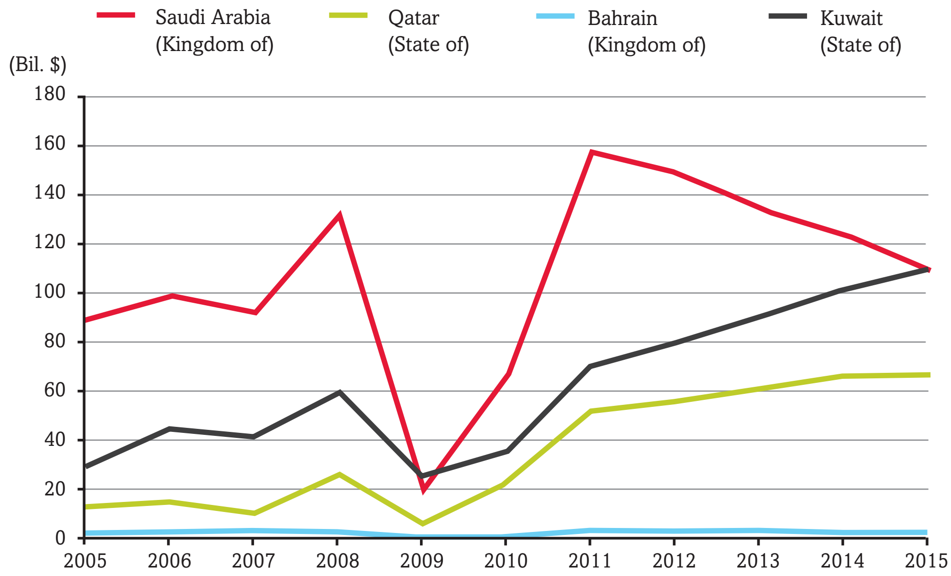


CHART 3

CURRENT ACCOUNT BALANCE -GULF COOPERATION COUNCIL



INTERNATIONAL ISLAMIC LIQUIDITY MANAGEMENT 2 SA'S US$500 MILLION LANDMARK ISLAMIC FINANCE PROGRAM ASSIGNED 'A-1' RATING

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OVERVIEW

- International Islamic Liquidity Management 2 SA is a financing vehicle established to issue short-term Sharia-compliant money-market instruments backed by long-term sovereign sukuk.
- We assigned our 'A-1' rating to the vehicle.
- The rating reflects, among others, the vehicle's eligibility criteria that require assets to have an 'A-1' rating, and structural considerations, including principal, profit, and liquidity tests governing new issuances.
- The rating also incorporates liquidity support currently in the form of a US$500 million primary-dealer agreement with Standard Chartered Bank.
- We also consider the intended bankruptcy-remote nature of the program in assigning the rating..

(Watch the related CreditMatters TV segment titled, "How International Islamic Liquidity Management's Landmark Finance Program Affects Islamic Finance," dated May 9, 2013.)

NEW YORK (Standard & Poor's) April 4, 2013--Standard & Poor's Ratings Services said today that it has assigned its 'A-1' rating to International Islamic Liquidity Management 2 SA's US$500 million Islamic finance program. The vehicle has been established with the sole purpose of purchasing sovereign, sovereign-linked or supranational sukuk assets with long-term ratings that correspond to an 'A-1' rating. In addition, the vehicle is to issue short-term Sharia-compliant certificates with maturity profiles of less than one year. The program is the first financing vehicle created for issuing such Sharia-compliant certificates. It will target Islamic commercial banks, who currently face a lack of adequate Sharia-compliant money-market instruments for liquidity management.

The rating on the program depends on the asset eligibility criteria of the vehicle, which among other requirements, limit the purchase of assets to those having a long-term rating corresponding to 'A-1'. Additionally, the transaction benefits from conditions restricting the issuance of certificates, which include minimum levels of liquidity, nondefaulted assets, and sufficient cash flows to cover profit and expenses of the vehicle.

Moreover, the vehicle benefits from liquidity support in the form of primary dealer agreements from 'A-1' rated financial institutions, currently provided through a US$500 million primary dealer agreement

with Standard Chartered Bank (AA-/A-1+). Under the agreement, Standard Chartered Bank is required to purchase up to US$500 million in certificates in any single auction. Also, the transaction is exposed to BNP Paribas Securities Services, Luxembourg Branch (A+/A-1), in its role as bank account provider. Under our counterparty
criteria, BNP Paribas holds a rating that is sufficient to support the rating on the program.

The International Islamic Liquidity Management 2 SA vehicle 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 Corp. (IILM). 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.

IILM will act as the program administrator of the vehicle. It is an international institution established in October 2010 by central banks from key Islamic finance jurisdictions and one multilateral institution, to address the lack of Sharia-compliant liquidity tools available to Islamic financial institutions. IILM was created pursuant to the International Islamic Liquidity Management Corporation Act of Malaysia, and is governed by the Articles of Agreement among its members. Under its mandate, it is charged with the role of issuing and holding U.S.-dollar-denominated sukuk with the intent of creating and distributing short-term Sharia-compliant financial instruments.

Standard & Poor's 17G-7 Disclosure Report

SEC Rule 17g-7 requires an NRSRO, for any report accompanying a credit rating relating to an asset-backed security as defined in the Rule, to include a description of the representations, warranties and enforcement mechanisms available to investors and a description of how they differ from the representations, warranties and enforcement mechanisms in issuances of similar securities.

STANDARD & POOR'S RATING LIST

TABLE OF RATED ISLAMIC FINANCIAL INSTITUTIONS

Issuer	Country	Type	Rating
Al Baraka Banking Group B.S.C.	Bahrain	Bank	BB+/Negative/B
Al Baraka Turk Katilim Bankasi AS	Turkey	Bank	BB/Negative/B
Al Khaleej Takaful Group (unsolicited rating)	Qatar	Insurance	BBBpi
Al Rajhi Bank	Saudi Arabia	Bank	A+/Stable/A-1
Al Sagr Cooperative Insurance Co.	Saudi Arabia	Insurance	BBB/Stable/--
BEST RE (L) Ltd	Malaysia	Insurance	B+/WatchDev
Best RE Family (L) Ltd	Malaysia	Insurance	B+/WatchDev
Dubai Islamic Insurance & Reinsurance Co. (Aman)	UAE	Insurance	BBB-/Stable/--
Hannover ReTakaful B.S.C.	Bahrain	Insurance	A+/Stable/--
Islamic Development Bank	Saudi Arabia	Multinational	AAA/Stable/A-1+
Jordan Islamic Bank	Jordan	Bank	BB-/Negative/B
Kuwait Finance House	Kuwait	Bank	A-/Negative/A-2
Malath Cooperative Insurance & Reinsurance Co.	Saudi Arabia	Insurance	BBB+/Stable/--
Mediterranean & Gulf Cooperative Insurance and Reinsurance Co.	Saudi Arabia	Insurance	A-/Stable/--
Noor Takaful Family PJSC	UAE	Insurance	BB+/Stable/--
Noor Takaful General PJSC	UAE	Insurance	BB+/Stable/--
Qatar Islamic Bank (S.A.Q.)	Qatar	Bank	A-/Stable/A-1
Salama/Islamic Arab Insurance Co. (P.S.C.)	UAE	Insurance	BBB+/Negative/--
Saudi Re for Cooperative Reinsurance	Saudi Arabia	Insurance	BBB+/Stable/--
Sharjah Islamic Bank	UAE	Bank	BBB+/Stable/A-2
Takaful Re. Ltd	UAE	Insurance	BBB/Stable/--
Tawuniya/The Company for Cooperative Insurance	Saudi Arabia	Insurance	A/Stable/--
Wataniya Insurance Co.	Saudi Arabia	Insurance	BBB/Stable/--
Weqaya Takaful Insurance & Reinsurance Co.	Saudi Arabia	Insurance	BBB/Stable/--
Wethaq Takaful Insurance Co. K.S.C. (Closed)	Kuwait	Insurance	BB/Stable/--

Source: Standard & Poor's Ratings Services. Note: Ratings as of Dec. 10, 2013

TABLE OF OUTSTANDING RATED SUKUK

Originator	Country	Sector	Date of Rating	LT FC rating
Islamic Development Bank	Saudi A.	Gov.	Various	AAA
Islamic Development Bank	Saudi A.	Gov.	2008	AAA
Emirate of Ras Al Khaimah	UAE	Gov.	2009	A
Petroliam National Bhd.	Malaysia	Corp.	2009	A-
Tourism Dev't and Inv't Co.	UAE	Gov.	2009	AA
General Electric	USA	FI	2009	AA+
Dar Al Arkan Real Est. Dvt. Co.	Saudi A.	Corp./SF	2010	B+
Government of Malaysia	Malaysia	Gov.	2010	A-
Central Bank of Bahrain	Bahrain	Gov.	2011	BBB
Republic of Indonesia	Indonesia	Gov.	2011	BB+
Emaar Properties PJSC [1st issue]	UAE	Corp./SF	2011	BB+
Government of Malaysia	Malaysia	Gov.	2011	A-
Sharjah Islamic Bank	UAE	FI	2011	BBB+
Republic of Indonesia	Indonesia	Gov.	2011	BB+
Central Bank of Bahrain	Bahrain	Gov.	2011	BBB
Abu Dhabi Commercial Bank	UAE	FI	2011	A
Majid Al Futtaim Holding	UAE	Corp.	2012	BBB
Saudi Electric Co.	Saudi A.	Corp.	2012	AA-
Saudi Electric Co.	Saudi A.	Corp.	2012	AA-
Banque Saudi Fransi	Saudi A.	FI	2012	A
State of Qatar	QAT	Gov.	2012	AA
Emaar Properties PJSC [2nd issue]	UAE	Corp./SF	2012	BB+
Development Bank of Kazakhstan	KAZ	Gov.	2012	BBB+
Axiata Group Bhd.	Malaysia	Corp.	2012	BBB-
Republic of Indonesia	Indonesia	Gov.	2012	BB+
Sime Darby Bhd.	Malaysia	Corp.	2013	A
Sharjah Islamic Bank	UAE	FI	2013	BBB+
Dubai Electricity Water Authority	UAE	Corp.	2013	BBB
Saudi Electric Co.	Saudi A.	Corp.	2013	AA-
Albraka Turk Katilim Bankasi AS	Turkey	FI	2013	B
IILM**	Malaysia	SF	2013	A-1
Dar Al Arkan Real Est. Dvt. Co.	Saudi A.	Corp./SF	2013	B+
Aldar Properties PJSC	UAE	Corp.	2013	BB

Source: Standard & Poor's Ratings Services. Note: Ratings as of Dec. 10, 2013

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2013-09-16	Qatar Islamic Banks Are On A Fast Track To Growth
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2011-09-07	Stronger International Ties Could Help Turkey's Nascent Islamic Banks Sustain Recent Growth
2011-08-11	Takaful Insurance Markets Continue to Grow Despite Operational Differences
2011-03-28	Potential Growth Ahead For Maghreb Insurers May Test Their Risk Management Abilities
2011-03-01	Global Standards Needed To Give Breadth And Depth To Growing Sukuk Market
2011-02-17	Saudi Arabian Insurance in 2011: Steady Growth In Insurable Activity Offset By Softening Growth
2010-10-11	Sukuk Funds Poised To Grow As Sukuk Market Continues To Expand
2010-07-27	Sukuk Issuance Is Up And Running, But Will The Climb Continue Apace?
2010-07-13	Takaful Insurance Has Long-Term Viability And Benefits From Expected Growth, But Stiff Competition Persists
2010-02-01	Islamic Finance Is Likely To Advance In 2010 On Firm Growth And Widening Geographic Reach
2010-01-27	The Sukuk Market Is Likely To Show Steady Growth In 2010
2009-09-02	The Sukuk Market Has Continued To Progress In 2009 Despite Some Roadblocks
2009-12-04	Islamic Banking Has Reached Critical Mass In The Gulf After Sustained Growth, And Expansion Is Set To Continue
2009-04-20	Islamic Sukuk Come Of Age In Infrastructure And Project Finance
2009-02-20	Rated Gulf Islamic Financial Institutions And Takaful Companies Have Shown Resilience To Global Market Dislocation, But They Are Not Risk Immune
2009-01-16	Sukuk Market Declined Sharply In 2008, But Long-Term Prospects Remain Strong
2008-09-09	Sukuk Market Continues To Grow Despite Gloomy Global Market Conditions
2008-07-14	Takaful Spreads Its Wings As An Alternative Insurance Business Model
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2004-11-22	Islamic Banking: A Unique Differentiation Strategy for Gulf Financial Institutions
2003-09-15	Rating Sukuk--How Rating Methodologies Apply to Islamic Debt Financing
2003-09-10	Malaysian Islamic Financing Risks Are Manageable
2002-11-27	Classic Ratings Approach Applied to Islamic Banks Despite Industry Specifics

Source: Standard & Poor's. The list excludes articles that are now outdated due to criteria updates.

GLOSSARY OF ISLAMIC FINANCE TERMS

The Five Pillars Of Islamic Finance

The ban on interest

Interest must not be charged or paid on any financial transaction, as interest (or the intrinsic value of the money) is deemed unlawful by Sharia.

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 fixed.

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.

Haram

Unlawful; prohibited by Sharia.

IFI

Islamic financial institution.

Ijara

Lease financing. 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 at the end of or during the rental period.

Investment risk reserve
The amount appropriated by an IFI from the income of 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), in order to create a cushion against future investment losses for 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 IFI provides capital to an enterprise or activity to be managed by the mudarib. Profits generated by that 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 IFI 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 IFI from mudaraba income before allocating the mudarib share (fee; mudarib refers to the IFI as a manager of the PSIA), in order to maintain a certain level of return on investment for PSIA holders.

PSIA (profit-sharing investment account)
A financial instrument relatively similar to time deposits of conventional banks. According to the terms and conditions of 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 IFI to invest his 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 laying down any restrictions).

Qard hasan
A loan granted for welfare purposes or to bridge short-term funding requirements; it 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.

Stability rating
A rating that represents Standard & Poor's current opinion about the prospective relative stability of cash flow distributable to PSIA holders.

Sukuk
Sharia-compliant financial certificates similar to bonds.

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

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

Wakala
An agency contract where the investment account holder (principal) appoints an IFI (agent) to carry out an investment on his behalf either for or without a fee.

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

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