

Sukuk Market Update

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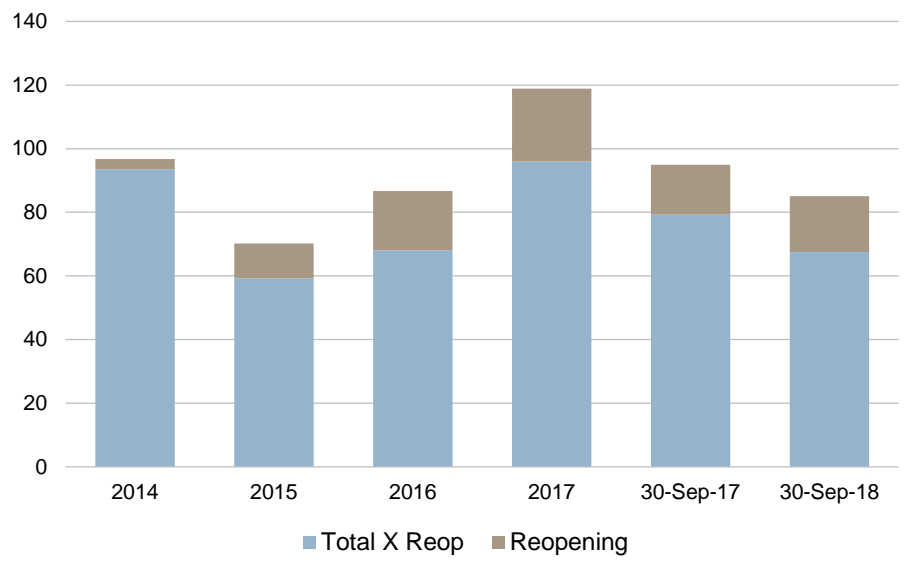


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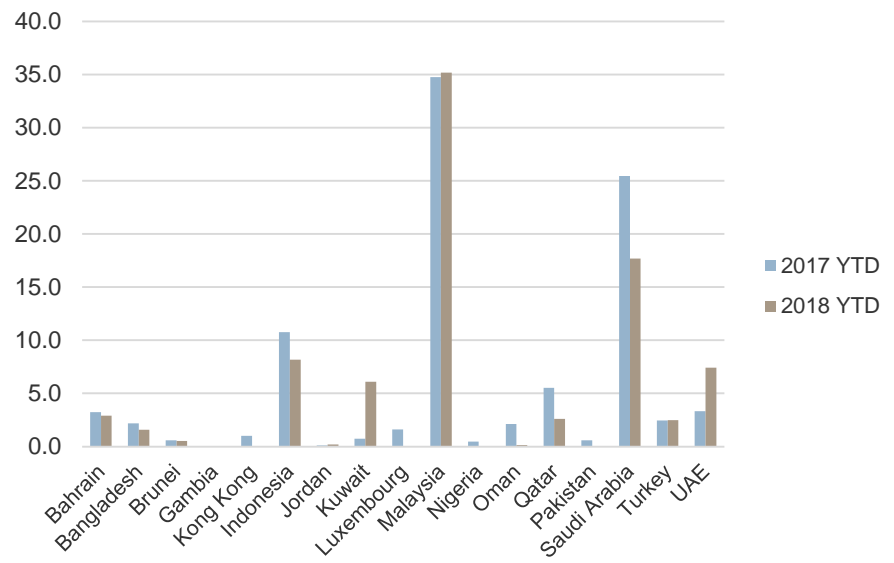


2017 Was A Strong Year For Sukuk...

Total Sukuk Issuance (2014-2018*)



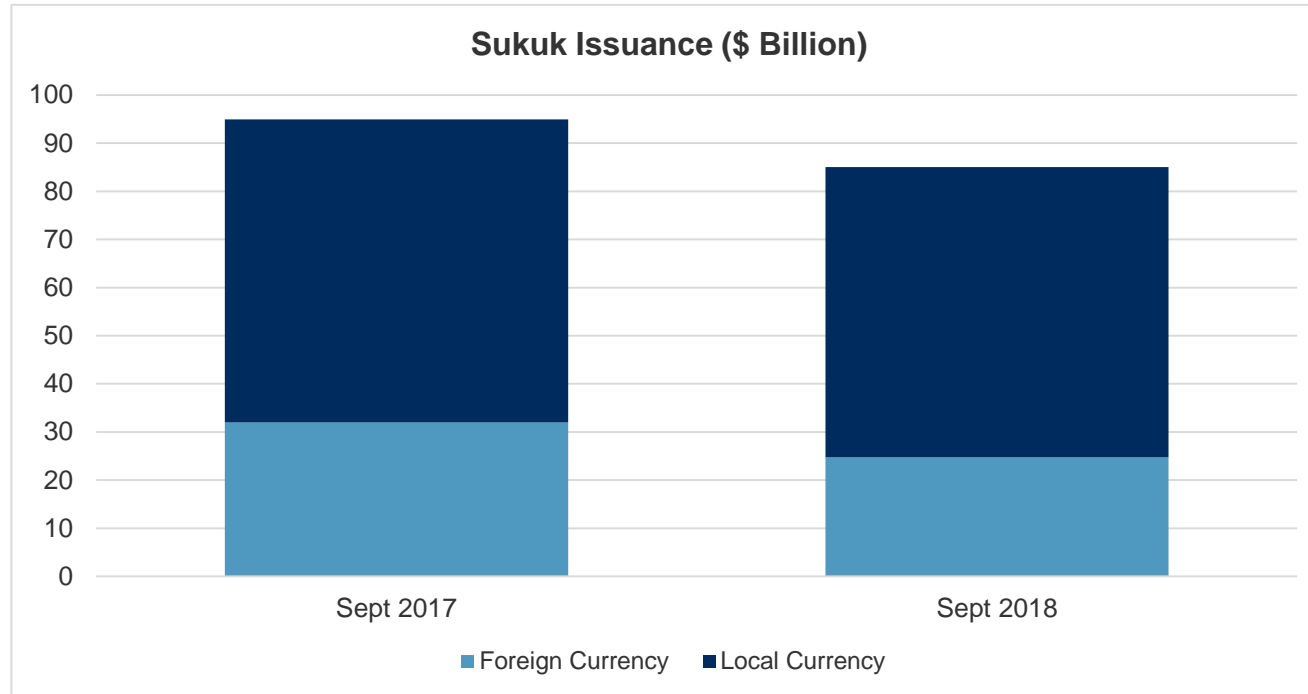
Distribution of issuance by geography



Source: S&P Global Ratings

- # \$96 billion in 2017 vs. \$68 billion in 2016 or an increase by 41%.
- # \$120 billion including re-opening in 2017 vs. \$87 billion in 2016 or an increase by 38 %.
- # Re-opening are issuance under unlimited local currency sukuk programme. (Primarily concentrated in Malaysia and Indonesia in the past / Saudi Arabia joined from 2018).

We Expect Lower Issuances In 2018 And 2019 Is Even More Uncertain



Source: S&P Global Ratings

The first nine months of 2018 were marked by a drop of around 10% of total issuance and 23% for foreign currency issuances.

Expectations \$70-80 billion in 2018 without re-opening (vs. \$68 billion at Sept. 30, 2018) and \$90-100 billion with re-opening (vs. 85 billion at Sept. 30, 2018).

2019 is even more uncertain...

Why?

#1 Global liquidity is tightening: Fed rate increase and ECB reducing its asset purchase pace. As a result, cost of funding for the issuers will rise and developed markets liquidity channeled to developing markets will reduce.

#2 Lower financing needs for GCC and uncertainty on the mix conventional-Islamic instruments that will be used.

#3 Higher geopolitical risks may deter investors' appetite to instruments issued by GCC issuers in case of significant escalation.

#4 The standardization agenda is progressing slowly although standard-setting bodies have spent a significant amount of energy on this agenda.

Trends to watch

More stringent application of the profit-and-loss-sharing principle: such a development could deprive the market of an important class of investors (fixed-income investors) and ultimately lead to higher pricing. Sukuk with loss sharing mechanisms can be rated but not at the same level as the senior obligations of their sponsors.

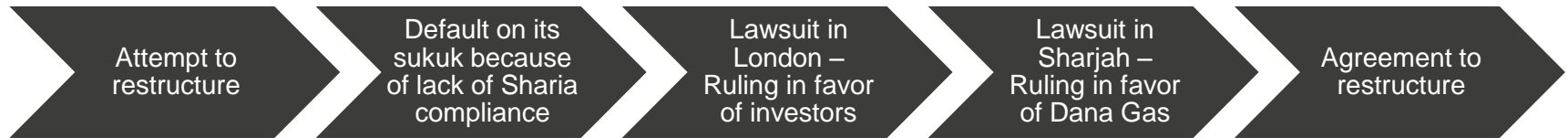
A broadening of the investor base to include retail investors or waqf money. Promoters of this idea believe that retail investment or waqf money could lift sukuk issuance and reduce pricing by boosting demand. We are of the view that waqf is after different objectives and retail involvement in sukuk requires a specific regulation. At this stage, a boost from the pension fund side and other institutional investors could be more helpful for the industry.

Resolution regimes and issuance of sukuk as ALAC.

Green Sukuk; specificities to some structures used in the GCC (Mudaraba-Murabaha structure)

Dana Gas Case

Dana Gas: Sequence of Reported Events



Investors are now more attentive to:

- 1- Sharia compliance: Additional legal wording to ensure that this case doesn't repeat itself.**
- 2- Enforceability of foreign judgement in local jurisdictions, especially for those governed by Sharia law.**
- 3- Some decided to simply exit the sukuk market or certain transactions.**

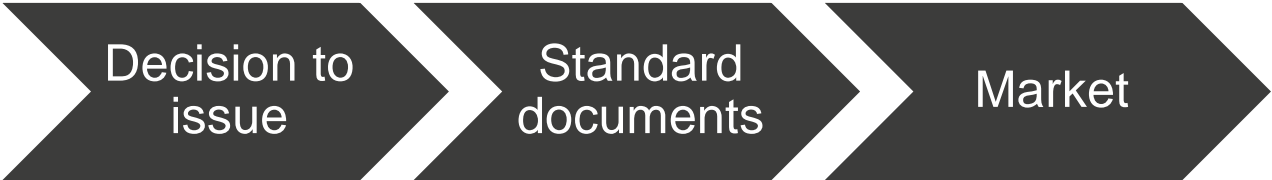
New clauses to prevent a new Dana Gas case...

- 10.1 it shall not claim that any of its obligations under this Agreement and the Transaction Documents to which it is a party (or any provision thereof) is *ultra vires* or not compliant with the principles of *Shari'a*;
- 10.2 it shall not take any steps or bring any proceedings in any forum to challenge the *Shari'a* compliance of this Agreement and the Transaction Documents to which it is a party; and
- 10.3 none of its obligations under this Agreement and the Transaction Documents to which it is a party shall in any way be diminished, abrogated, impaired, invalidated or otherwise adversely affected by any finding, declaration, pronouncement, order or judgment of any court, tribunal or other body that this Agreement and the Transaction Documents to which it is a party are not compliant with the principles of *Shari'a*.

Some recent changes in the legal documentation might point to weakening contractual obligations of sponsor (ex. In case of early dissolution, payment to investors on a date that is to be determined by the delegate (with no specific definition of the time elapsed between the occurrence of early dissolution event and timing of payment)).

Standardization and reduction of complexity is the way forward...

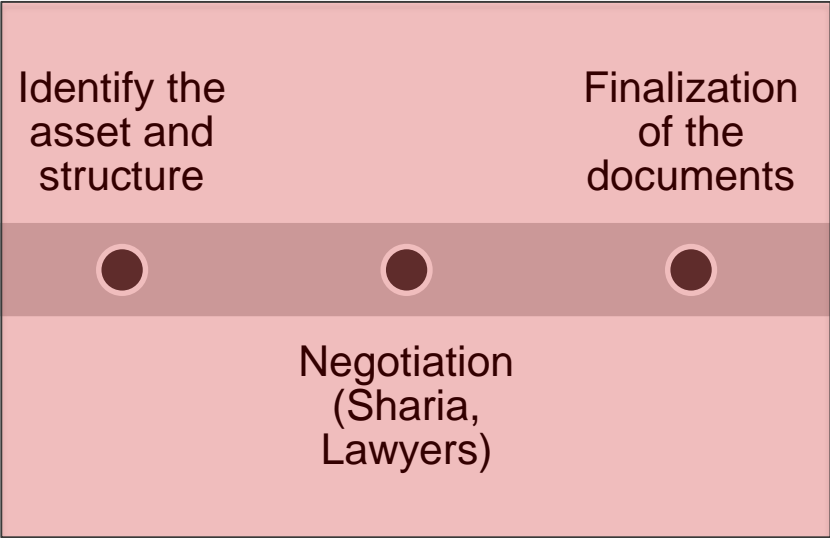
Bond



Sukuk

Decision to issue

Adjustment of legal environment



Is Standardization achievable?

Sharia and Legal Standardization

- 1- Several school of thoughts in Islam with different interpretation: impossible to unify?
- 2- Top 3 Sharia Scholars sit on 70 different boards
- 3- Once a fatwa is issued for a sukuk, the effective compliance is not tracked unless the sukuk is issued by an entity that is subject to Sharia compliance audit.
- 4- There are different local regulatory requirements that an issuer needs to comply with.

Opportunities

- 1- AAOIFI has existing Sharia standards but they are not enforced consistently in all the Islamic finance jurisdictions.
- 2- Central Sharia Boards are not present in all the jurisdictions
- 3- External Sharia audit could help shifting the attention from Ex ante approval to Ex post audit and compliance assurance.
- 4- The most important contracts are usually based on English Law and the legal language used is standardized to a large extent.

Short answer: Standardization is not only achievable but is also desirable.

Methodology for rating sukuk



Methodology for rating sukuk

We rate a long-term sukuk... and assign it an issue credit rating at the same level as the sponsor's senior unsecured rating, if the next five conditions (A-E) are met:

A.) The contractual payment obligations of the sponsor to the issuer are sufficient for full and timely periodic distributions and final payments of principal (on the scheduled dissolution date or in case of early dissolution);

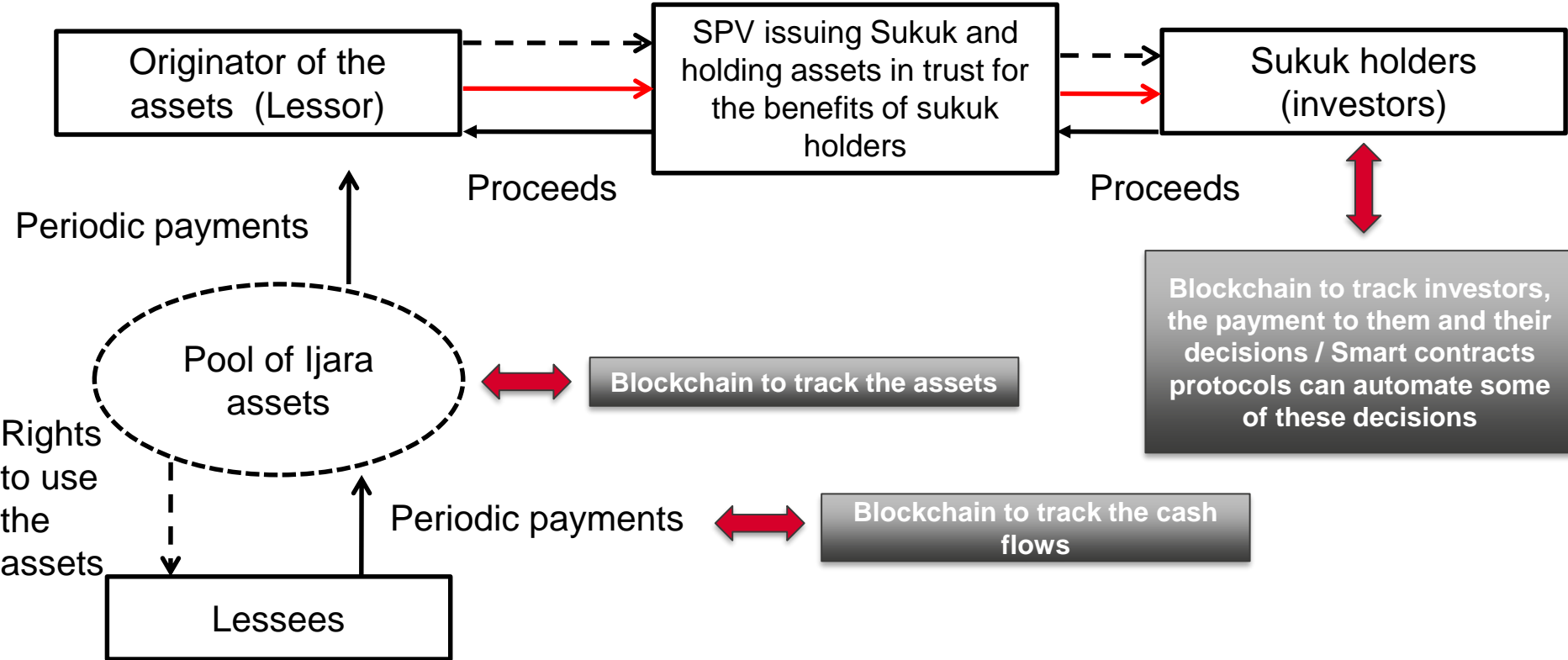
B.) The sponsor's contractual payment obligations rank pari passu with the sponsor's other senior unsecured financial obligations (if they do not, but the other four conditions are met, see paragraphs 10 and 25).

C.) The sponsor's contractual payment obligations are irrevocable;

D.) The sponsor commits to fully and unconditionally pay all foreseeable costs of the issuer including taxes and costs related to the trustee, service agent, and investment manager through the life of the transaction, in a timely way, so as not to weaken the issuer's ability to meet all payments due in a timely way;

E.) We assess as remote the risks that conditions, such as those mentioned in paragraphs 16 to 20, jeopardize full and timely payments (as defined by our criteria, see paragraph 12). If we believe these risks are non-remote, we may assign an issue credit rating on the sukuk that is different from the equivalent sponsor issue credit rating according to paragraphs 22 or 24.

Sukuk and Blockchain: A perfect match?



- Cash
- - - → Non cash
- (Red) Periodic (and final) distribution to sukuk holders

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