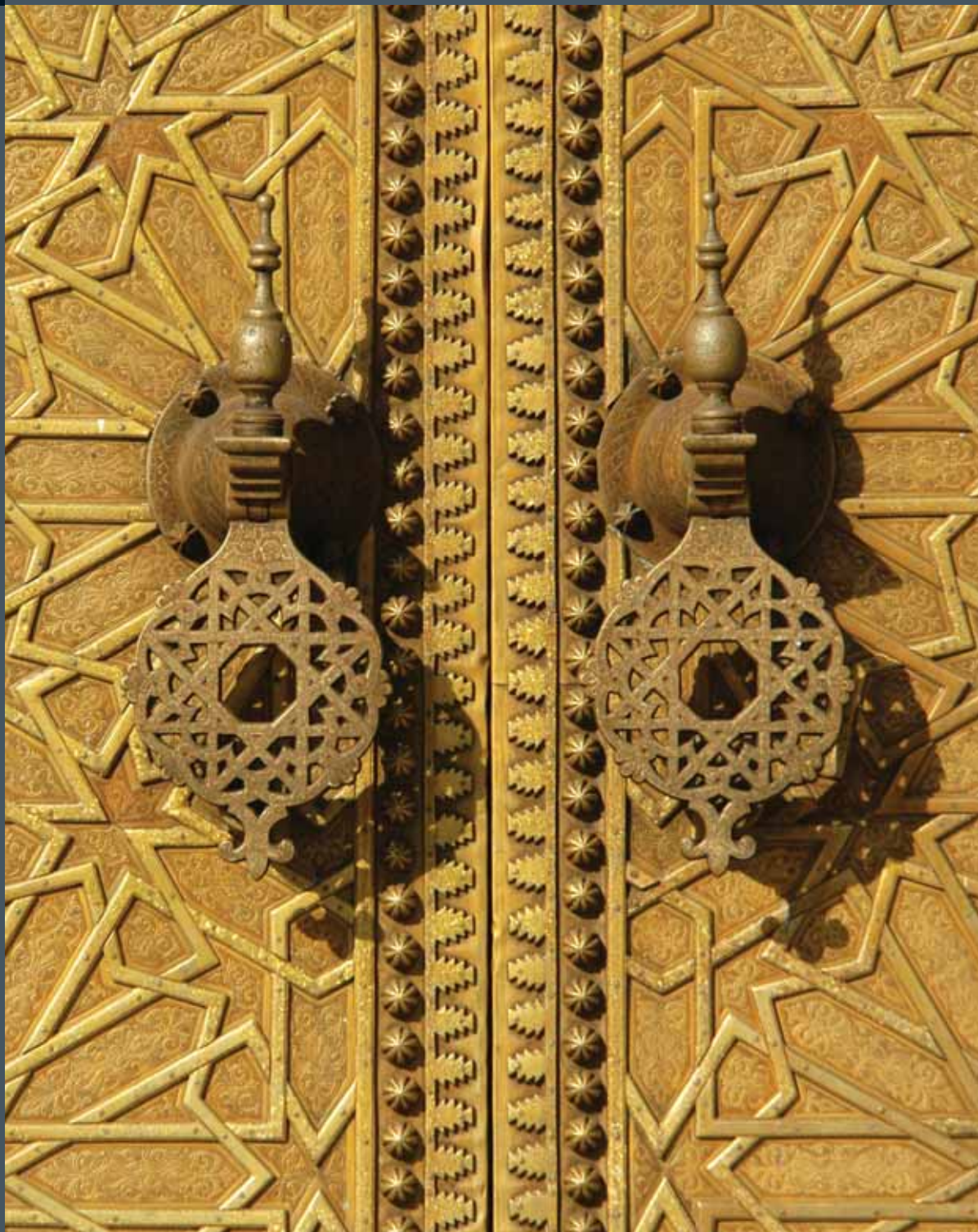


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Islamic Finance Outlook 2009



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FOREWORD

The growth of Islamic finance remained strong in 2008, despite the global financial dislocation and its spread to economies around the world. Standard & Poor's Ratings Services continues to foresee a bright outlook for Islamic finance, despite the hurdles ahead in 2009. We are committed to continue accompanying this expansion, providing market participants with objective and independent opinions on the creditworthiness of Sharia-compliant issuers and issues.

We again widened our coverage of Islamic finance in 2008, adding ratings on sukuk notes and takaful companies. In particular, we rated for the first time the three tranches of a sukuk with no "guarantee" mechanism, issued by Sun Finance Ltd. (Sorouh Abu Dhabi Real Estate LLC). We believe that the outlook for asset-backed sukuk is positive despite the doubts raised by the disruption in global financial markets and in structured finance. Still, we note the sukuk market suffered heavily in 2008: Liquidity dropped sharply, spreads widened, and investors showed lower appetites. Total sukuk issued around the globe fell to \$14.9 billion during the year, compared with more than \$34 billion in 2007. We expect a revival in the sukuk market during the second half of 2009 at the earliest, and most likely only in 2010. The long-term pipeline for sukuk issuance is healthy, and the market is attracting interest from an increasing number of issuers in both Muslim and non-Muslim countries.

Islamic financial institutions have remained somewhat insulated from the global financial downturn because Sharia law strictly prohibits them from handling interest-based instruments. This means that Islamic banks didn't invest in structured products and so haven't suffered from the fall in these instruments' values. The knock-on effects of the current economic slowdown, however, are pressuring Islamic financial institutions and creating new obstacles in their development path. We see specific sources of risk stemming from the deepening economic slowdown in many countries, scarce liquidity, pronounced stock market declines, and plummeting real estate prices. Standard & Poor's has taken some negative rating actions on some Islamic banks over the past six months to reflect these adverse changes.

When economies begin pulling out of the downturn, we expect Islamic finance to resume its rapid growth and continue attracting interest from investors around the world. Standard & Poor's estimates that Sharia-compliant assets worldwide total about \$700 billion following growth exceeding 10% annually during the past decade. Islamic finance has become a recognized and specific asset class on its own. Interest in this compartment of global finance is increasing rapidly in nontraditional centers of Islamic finance. For instance, France and the U.K. are moving to extend Islamic finance into their respective banking systems. Certain Asian and African countries have entered the league of countries issuing sukuk, with others expected to join in the future.

Standard & Poor's remains dedicated to continue serving the specific needs of Islamic finance and related investors through our ratings; our tailored products, such as stability ratings for banks offering profit sharing investment accounts; and equity indices, including newly launched indices that track Sharia-compliant companies.

We are very pleased to release this updated Islamic finance brochure. The publication includes topical research on Islamic finance, our specific rating methodologies in this realm, and selected analyses. Additional detailed analyses are available on RatingsDirect, Standard & Poor's Web-based credit analysis system. Through our knowledge of Islamic finance and its key players, we consistently aim to share objective and accurate insights into Islamic finance for the benefit of all market constituents.



Paul Coughlin

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Islamic Issues & Issuers

Rated By Standard & Poor's April 10, 2009

ISSUE CREDIT RATINGS				
Originator	Date of rating	Issue amount (mil. \$)	Long-term foreign currency rating	
1	Central Bank of Bahrain Sukuk	Various	995	A
2	DIB Sukuk Co. Ltd.	Feb. 15, 2007	750	A-
3	DP World Sukuk Ltd. (DP World)	June 27, 2007	1,500	A
4	Dubai Sukuk Centre Ltd.	May 25, 2007	1,250	A
5	EIB Sukuk Co. Ltd. (Emirates Bank International)	May 15, 2007	1,000	A
6	GFH Sukuk Ltd. (Gulf Finance House)	June 26, 2007	1,000	BBB-
7	Gold Sukuk dmcc (Dubai Multi Commodities Centre Authority)	April 11, 2005	200	A-
8	Golden Belt 1 B.S.C.	April 18, 2007	650	BBB+
9	IDB Trust Services Ltd. (Islamic Development Bank)	May 20, 2005	1,000	AAA
10	JAFZ Sukuk Ltd.	Nov. 8, 2007	AED7.5 billion	A
11	Loehmann's Capital Corp. (Loehmann's Holdings Inc.)	Sept. 22, 2004	110	CCC-
12	MBB Sukuk Inc.	April 11, 2007	300	BBB+
13	Pakistan International Sukuk Co.	Dec. 23, 2004	600	CCC+
14	Qatar Global Sukuk QSC	Sept. 10, 2003	700	AA-
15	RAK Capital (Emirates of Ras Al Khaimah)	May 6, 2008	2,000	A
16	Sarawak Corporate Sukuk Inc.	Nov. 30, 2004	350	A-
17	Saudi Basic Industries Corp.	Various	SAR16 billion	A+
18	Sharjah Islamic Bank Sukuk	Sept. 12, 2006	255	BBB
19	Stichting Sachsen-Anhalt Trust	July 9, 2004	130	AA-
20	Sukuk Funding (No.2) Ltd. (Aldar Properties PJSC)	May 22, 2008	AED3.8 billion	A-
21	Sun Finance Ltd. (Sorouh Abu Dhabi Real Estate LLC)	July 21, 2008	AED4 billion	A/BBB+/BBB-
22	Tabreed 06 Financing Corp. (National Central Cooling Co. PJSC)	June 15, 2006	200	BB
23	Tabreed 08 Financing Corp. (National Central Cooling Co. PJSC)	Dec. 2, 2008	AED1.7 billion	B
24	Tadamun Services Berhad (Islamic Development Bank)	July 17, 2008	MYR1 billion	AAA
25	EMAAR Sukuk Ltd. (Emaar Properties PJSC)	April 8, 2009	\$2 billion	BBB+

ISSUER CREDIT RATINGS				
Issuer	Date of rating	Country	Long-term foreign currency rating	
1	Albaraka Banking Group (B.S.C.)	March 21, 2007	Bahrain	BBB-
2	Al Rajhi Bank	Oct. 5, 2005	Saudi Arabia	A
3	Arcapita Bank B.S.C.	Nov. 16, 2006	Bahrain	BB/Watch Neg
4	B.E.S.T. Reinsurance Co.	Sept. 2, 1997	Tunisia	BBB+
5	Dubai Islamic Bank	Oct. 18, 2006	United Arab Emirates	A-/Watch Neg
6	Dubai Islamic Insurance & Reinsurance Co. (Aman)	Nov. 17, 2008	United Arab Emirates	BBB
7	Gulf Finance House	Aug. 7, 2006	Bahrain	BBB-
8	Hannover ReTakaful B.S.C.	Dec. 4, 2007	Bahrain	A
9	Islamic Development Bank	Dec. 19, 2002	Saudi Arabia	AAA
10	Kuwait Finance House	Aug. 24, 2004	Kuwait	A-/Watch Neg
11	Salama/Islamic Arab Insurance Co. (P.S.C.)	May 24, 2007	United Arab Emirates	BBB+
12	Sharjah Islamic Bank	Sept. 6, 2006	United Arab Emirates	BBB
13	Takaful International Co. BSC	Dec. 22, 2008	Bahrain	BBB
14	Takaful Re Ltd.	Oct. 31, 2006	United Arab Emirates	BBB
15	Wethaq Takaful Insurance Co. K.S.C. (Closed)	Sept. 22, 2008	Kuwait	BBB-

AED: United Arab Emirates dirham. SAR: Saudi Arabian riyal. MYR: Malaysian ringgit.

Rated Gulf Islamic Financial Institutions And Takaful Companies Have Shown Resilience To Global Market Dislocation, But They Are Not Risk Immune

Global financial market disruption, the liquidity crunch, slowing economies, and sharply falling stock markets have adversely affected recent performance at numerous financial institutions around the world. Standard & Poor's Ratings Services believes that Islamic financial institutions (IFIs) have felt the repercussions less because Sharia law prohibits interest-based financial products. In other words, IFIs didn't invest in some impaired asset classes that have hampered many conventional banks' financial profiles and performance.

We note, however, the squeeze that current market conditions are putting on many Islamic banks and takaful insurance companies. For instance, we see as sources of stress the liquidity dry-up, mounting pressure on the real estate sector in the Gulf Cooperation Council (GCC) countries, the sharp correction in regional stock markets, and certain investments made by IFIs--mainly investment banks--in European or U.S. companies and real estate. In our opinion, most IFIs should be equipped to weather this financial downturn and keep the effects on their financial profiles at manageable levels. However, like their conventional peers, IFIs stand to post weaker financial performance and asset quality indicators, in our view, in the coming quarters. Among others, we see the real estate sector slide as one of the chief sources of risk for IFIs.

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Publication date:
20-Feb-2009

Our Recent Rating Actions On Islamic Banks

We have taken various negative rating actions over the past three months on both conventional and Islamic banks, largely because of the impact of the deteriorating economic landscape on these entities. When it comes to Islamic banks in GCC countries, we have:

- Lowered the long- and short-term counterparty credit ratings on Dubai Islamic Bank to 'A-/A-2' from 'A/A-1' and revised the outlook to negative from stable;
- Revised the outlook on Sharjah Islamic Bank to stable from positive and affirmed the 'BBB/A-2' ratings;
- Revised the outlook on Gulf Finance House to negative from stable and affirmed the 'BBB-/A-3' ratings;
- Put the 'A-' long-term rating on Kuwait Finance House on CreditWatch with negative implications and affirmed the 'A-2' short-term rating; and
- Lowered the ratings on Arcapita Bank B.S.C. to 'BB+/B' from 'BBB/A-2' and placed them on CreditWatch with negative implications.

We See No Exposure To Structured Products For IFIs

Sharia principles prohibit IFIs from handling interest-based products, which are the main foundation of structured financial instruments. Consequently, IFIs have no exposure to these instruments. We note that IFIs, unlike certain of their conventional counterparts, have not had to book write-downs corresponding to the falling market value of these assets. In the first nine months of 2008, commercial Islamic banks that we rate continued to exhibit strong profitability in our view, reporting an average return on assets (ROA) of 3.1% in the period. These banks appear to have benefited from the supportive economic environment that prevailed in the first half of 2008, their good efficiency, and low cost of risk. Their average ROA at end-September 2008 compares with 3.7% at year-end 2007, when we observe that banks' revenues were inflated by an unsustainable brokerage income flow and rapid growth in loan portfolios. In the months to come, we believe that rated IFIs' financial performance will deteriorate because we expect them to book some market-related provisions covering their exposure to the dropping values of stock markets and to Sharia-compliant investment products (mainly sukuk notes and funds). In the next few quarters, the anticipated slowdown in loan growth, inflated cost of funding, and increase in cost of risk also stand to test IFIs' performance.

Liquidity Is Drying Up And Funding Costs Are Increasing

Events over the past 18 months have triggered a sharp decline in available liquidity around the globe. Investors have adopted a wait-and-see stance, reducing their risk appetites and seeking higher returns. In the Gulf region, home to most IFIs that we rate, we note that the "hot" money inflow into GCC countries in anticipation of a possible revaluation of Gulf local currencies--the currencies of five of the six GCC countries are pegged to the dollar--ceased and rapidly reversed in 2008. At the same time, loan growth remained high in the first nine months of the year. Like their conventional peers, IFIs were ill prepared, in our view, to enter an environment where liquidity became scarce and cost of funds increased.

Still, GCC countries have announced that they stand ready to support their financial systems if needed. The Central Bank of the United Arab Emirates (UAE) set up a liquidity facility totaling United Arab Emirate dirham (AED) 50 billion (\$13.6 billion), and the finance ministry placed additional deposits of AED70 billion (\$19 billion) to ease liquidity pressure on banks operating in the UAE. We believe that providing support to IFIs is more complicated than for conventional banks, because governments can't use the same mechanisms as those for conventional institutions. For instance, interest-based repo facilities or traditional deposits aren't Sharia compliant. The UAE has based its support to IFIs on wakala, which has required some time to implement.

The still-adequate liquidity that we understand is available at rated Islamic commercial banks partially mitigates liquidity risk. On Sept. 30, 2008, these banks recorded, according to our estimates, a ratio of liquid assets to total assets of 19.9%. We understand that this ratio continued to decline in the final quarter of 2008, however, albeit remaining adequate. We note that rated IFIs rely heavily on their customer deposits to finance their loan portfolios; we estimate that these IFIs recorded a ratio of total loans to deposits of 94.2% on Sept. 30, 2008. We expect the liquidity crunch to constrain growth at conventional and Islamic banks in the Gulf and to increase their cost of funding. We also believe that a decline in loan offerings could accelerate the correction in the real estate market. This sector is one of the main sources of risk for the region's banks, including Islamic institutions, in our view.

We understand that IFIs' instruments for managing liquidity are scarce compared with those of conventional counterparts. IFIs generally place any excess available liquidity with other international or local banks through Sharia-compliant instruments (mainly international murabaha). The market for sukuk notes remains fairly illiquid because no developed secondary market exists. We understand that investments in sukuk are mainly classified as held to maturity. We are of the view that IFIs could take advantage of the current challenging times to innovate and broaden the offering of acceptable instruments for liquidity management.

Lack Of Liquidity Is Squeezing Sukuk Issuance

A look at sukuk market performance in 2008 shows the dent that the liquidity crunch has made in issuance. Total sukuk issuance worldwide reportedly declined to \$14.9 billion in 2008, compared with more than \$34.3 billion a year earlier. Still, we continue to foresee positive prospects for the sukuk market in the long term. Turning to the coming quarters, however, we expect sukuk issuance to recover, at the earliest, during the second half of 2009 or, most probably, in 2010. Although volumes dropped steeply in 2008, we note that the sukuk market attracted about the same number of issuers. The market's estimates of the current pipeline of potential sukuk issues are in excess of \$45 billion. In our view, several factors support the sukuk market's sustainable growth, including the increasing popularity of Sharia-compliant financial instruments, governments' increasing openness to Islamic finance around the world, substantial investment and financing needs in the Gulf, and issuers' desire to tap investors from the Middle East and Muslim Asia. We understand that issuers from more than 20 countries have expressed interest in issuing, or have announced their intention to issue sukuk. We also anticipate that several additional sovereign issuers could enter the market.

Sharp Stock Market Correction Also Fuels Risks For IFIs

Liquidity management is challenging for IFIs due to the lack of liquid Sharia-compliant asset classes, as we mentioned above. Certain Islamic banks consequently invested in equities, exposing themselves to the correction in stock markets in recent quarters. We believe that the correction's effects on rated IFIs are likely to be relatively limited, from a solvency perspective. The Islamic banks we rate carry relatively low exposure to stock markets, amounting to less than 5% of total reported assets on Sept. 30, 2008. Capitalization is also strong, as shown by the ratio of adjusted total equity (ATE) to assets for the commercial Islamic banks that we rate, at 16.5% on Sept. 30, 2008.

Stock market volatility is not new in the region. Gulf stock markets experienced a pronounced correction in 2006, when the region's banking systems displayed resilience. The magnitude of the 2008 fall is greater than past declines, however. We consequently expect to see marked negative effects on profitability of rated IFIs in the fourth quarter of 2008, possibly spilling over into the ensuing quarters.

Value Of Islamic Private Equity Firms' Investments In Europe And The U.S. Poised To Drop

Islamic investment banks that operate largely as private equity firms are also, in our view, feeling the impact of global market conditions because they have invested in the real estate markets and companies outside the Gulf region, through private equity transactions. We believe that falling real estate prices, the credit crunch, and the economic recession in Europe and the U.S. are set to lessen the value of these investments and push these Islamic investment banks to either enlist their generally sophisticated clients' support to share any losses or to write down losses to preserve their reputations. We expect any potential losses to translate into lower

financial performance at these banks, compared with results delivered over the past couple of years. Indeed, because we see investors deserting alternative asset classes, at least for the moment, we believe that rated IFIs' ability to place or exit deals will be significantly strained. The adverse impact on their profitability and liquidity could also be material, in addition to the expected negative revaluation of their investment portfolios and the increase in cost of funds since these institutions are wholesale funded. Effectively illustrating this is Arcapita Bank, which has reported significantly deteriorated liquidity and where we expect 2009 financial performance to decline versus historical levels. Arcapita is currently implementing a set of corrective measures; we believe that the impact of these measures will contribute to our assessment of the bank's credit profile.

IFIs Are Not Risk Free

IFIs take risks: One of the pillars of Islamic finance states that all the participants in a transaction must share the risks and rewards. For further details on our views on the risks associated with IFIs, from a rating perspective, see "Risk Management For Islamic Financial Institutions: A Rating Perspective," published Jan. 15, 2008, on RatingsDirect. In this report, we focus on various risks that IFIs face in the current environment. The major risk arises from their exposure to the real estate sector and is common to IFIs and their conventional counterparts. We note that real estate financing in the Gulf grew considerably over the past three years.

According to Islamic finance principles, all transactions must be backed by a tangible asset. Therefore, one of the preferred asset classes of Islamic banks is real estate. We calculate total direct exposure to the real estate sector for IFIs that we rate at the equivalent of about 20% of total loans, which, in our opinion, is high and makes IFIs vulnerable to the correction in this previously fast-growing sector. In addition, we believe that certain loans to individuals granted by Islamic banks were used to finance real estate transactions. We consequently expect potentially significant negative repercussions on asset quality and profitability at rated IFIs if the ongoing correction in the real estate sector in GCC countries, and especially in the Emirate of Dubai, continues.

A second risk stems from certain Islamic banks' reliance on profit-sharing investment accounts (PSIAs) for funding in an environment where competition to attract deposits is stiff and remuneration has increased. IFIs have some lines of defense, however, primarily in the form of profit equalization reserves that we believe they could constitute in profitable years to cover for declines in less profitable years. Moreover, we understand that IFIs could reduce mudarib fees and use investment risk reserves to cover unexpected losses on investments or financing made on behalf of PSIA holders. To date, we understand the Islamic banks that we rate have constituted a fairly limited amount of profit equalization and investment risk reserves to reduce PSIA risk.

Takaful Insurance Displays Strong Resilience

Takaful insurers and reinsurers have so far demonstrated resilience to toughening market conditions, and we expect this to continue. We attribute their resilience to sufficient liquidity flows--in part due to reportedly higher new business--to service normal claims levels, and to capital adequacy, which, despite being affected in the current climate, remains supportive of the ratings across the sector. These positives are, in our view, partially offset by an investment focus on assets currently experiencing considerable volatility and high reliance on reinsurance capacity.

Takaful and retakaful players, although established for some time now, have achieved critical mass only in the past few years, during which we have witnessed increasing interest and acceptance of their business model. Attesting to this is these insurers' reported rapid growth in gross premiums written, which we believe is driven by consumers switching from conventional insurance or entering the takaful market for the first time, including for life takaful products; the differences in conventional and takaful insurance products; a widening range of takaful business lines; and legislative changes favorable to takaful insurance activity. We note that this growth, combined with a stable claims environment, has provided takaful and retakaful operators with a steady cash inflow through which to settle claims.

Claims settlement appears further supported by operators' liquid investment portfolios in both participant and shareholder funds. The liquid investment portfolios reflect the largely short-term nature of their business. Investment portfolios' assets range from low-risk murabaha (bank term deposits) to high-risk nonlisted equities, but we believe they currently comfortably exceed net outstanding claims. For this to continue to be the case, however, markets must remain liquid enough to allow the pricing of such assets. Credit risk, through market volatility and uncertainty in asset pricing, could lead to reduced earnings in the takaful segment, with lower investment income combined with high use of reinsurance protection--both regional and international--for certain risks. However, takaful and retakaful insurers' generally adequate-to-strong capital adequacy relative to risks written is, in our opinion, a significant compensating factor.

Risk Management For Islamic Financial Institutions: A Rating Perspective

Analyzing different risk categories and their management is a critical step in assessing the creditworthiness of all types of banks. Overall, there is no material difference between our analysis of the risks and enterprise risk management of Islamic banks and of conventional ones. However, the former display unique features--relating to credit, market, funding and liquidity, and other risks--that need to be considered and which have an impact on our rating process. Profit-sharing investment accounts (PSIAs), liquidity management, real estate exposure, and operational risks are among the elements that we focus on when assessing the creditworthiness of an Islamic financial institution (IFI).

Over the past decade, Standard & Poor's Ratings Services has developed strong expertise in the field of Islamic finance. We have adapted and refined our rating methodology to address the specifics of operations carried out by IFIs. It is important to note, however, that our opinions relate only to the creditworthiness of an IFI or a specific debt instrument, not to its degree of compliance with Sharia.

Credit Risk: First Lien Access To Collateral But Foreclosure Is Difficult

One of the five pillars of Islamic finance (see appendix), the obligation to back any transaction by a tangible, identifiable, underlying asset, means that IFIs--at least in theory--back their transactions with collateral. Consequently, collateral coverage is usually higher for IFIs than for conventional banks.

Contrary to conventional banks, whose customers are not obliged to disclose the purpose of their borrowings, Islamic banks finance the acquisition of identifiable assets of which they have legal ownership, in most cases, until maturity and final repayment. This is notably the case for "ijara" (lease financing) operations, in which the bank acquires the asset and leases it to the customer, with ownership transfer taking place only at maturity. The bank, as the legal owner of the asset, is therefore in a favorable position to foreclose on this asset (in the case of a default), and sell it on a secondary market.

In practice, however, collateral foreclosure can be much more difficult, especially for residential real estate. Given the take-off in residential real estate lending in Gulf Cooperation Council (GCC) countries, this question of foreclosure is set to become critical (including for Sharia-compliant securitization). Although an Islamic bank is in theory in a position to evict a customer from a property and resell it in the case of a default on the loan backed by the property, this would be unlikely to happen in practice owing to its "social responsibility." There are, however, instances when such a decision may be taken by a bank and authorized by its Sharia board--notably when specific conditions were set out and agreed upon before the conclusion of the transaction. In such cases, foreclosure may be easier than for conventional banks, as the property belongs to the Islamic bank. As a matter of fact, this type of structuring is sometimes used by conventional banks, as it is a strong way of reducing the problem of foreclosure. However, when the financing is based on other Sharia-compliant schemes where the property is not registered in the bank's name, the IFI will find itself in the same position as its conventional peers.

Certain transactions carried out by Islamic banks can bear above-average credit risk. For instance, some Islamic banks are involved in "musharaka" (venture capital financing) and "mudaraba" (trust financing), which are equivalent to participation transactions, increasing

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Publication date:

15-Jan-2008

the risks carried by the bank. In addition, in "murabaha" (mark-up financing) and ijara, the existence of full collateral could lead Islamic banks to be less vigilant when assessing the creditworthiness of their borrowers.

The credit risk of an IFI can also be influenced by the way its operations are funded. Under Accounting and Auditing Organisation for Islamic Finance Institutions (AAOIFI) reporting standards, there is a clear separation between assets financed through equity and assets financed through PSIAAs. One example of this can be found in the financials of Shamil Bank of Bahrain. In the case of a default on some assets financed through PSIAAs, the holders are, in theory, supposed to share in the losses. Thus, funding a loan portfolio through PSIAAs could be viewed as a partial transfer of credit risk from an IFI to PSIA holders. However, in practice there is a strong incentive for the bank to take the hit through a reduction of its "mudarib" fee (for acting as a manager of PSIAAs) or through its reserves. Indeed, a loss could trigger some PSIA holders to withdraw their funds, which could translate into liquidity problems. Standard & Poor's believes that IFIs would be inclined to support PSIA holders in the case of issues related to the credit quality of the underlying portfolio. Therefore, the loss-absorbing nature of these instruments is not completely certain.

Market Risks: Structured Products Are Generally Forbidden And Hedging Instruments Are Limited

The management of market risks is made more difficult for Islamic banks due to the limited number of risk management tools/instruments available to them. For example, it is difficult for an IFI to use hedging instruments such as derivatives as they are generally forbidden. On a positive note, the prohibition of "gharar" (speculation) usually tempers the risk profile of Islamic banks simply by limiting the size of their trading operations. Market risk for IFIs can be divided into three categories:

- **Margin risk.** This results from a mismatch between the yield earned on the bank's assets and that served on its liabilities. For instance, a bank can find itself exposed to margin risk when a portfolio of murabaha (with fixed margins) is financed through PSIAAs (with variable margins). As Islamic scholars usually forbid recourse to derivatives, this risk can be difficult to hedge. In some cases, IFIs can employ nascent Sharia-compliant hedging techniques. Dubai Islamic Bank (DIB) and Deutsche Bank AG have stated that they have established the first ever Sharia-compliant profit rate collar. For less sophisticated IFIs, the matching of floating and fixed yields can be used as a natural way to cover these risks. An ijara portfolio--with a floating margin or repricing characteristics--could be used to reduce an IFI's exposure to margin risk resulting from the use of PSIAAs as a funding source. As IFIs usually benefit from a large portion of unremunerated deposits, as is the case for Saudi Arabia-based Al Rajhi Bank, this can also be a good mitigating factor for margin-related risks.
- **Investment risk.** IFIs are forbidden from speculating, which means that trading risk is limited. In addition, as most complex structured products are usually not considered Sharia compliant, IFIs cannot invest in them. The exposure of IFIs to investment risk is therefore limited to that stemming from equity markets, Sharia-compliant debt products (such as sukuk), and real estate. Given that the secondary market for sukuk is very limited, the risk relating to these instruments mainly stems from credit quality rather than from market movements. Although IFIs that invest in stock markets are exposed to swings in equity prices, direct exposure to these markets is usually limited. We have seen some opportunistic investments made by IFIs over the past three years in order to benefit from the boom in GCC stock markets, but the correction that took place in 2006 provided a strong incentive to limit these exposures. IFIs are usually significantly exposed to the real estate sector, as it is compliant with Sharia principles. Some Islamic banks in the GCC have significant

exposure to this sector (directly or indirectly through collateral), which is negatively factored into our ratings. DIB is an example of such a bank, with significant direct and indirect exposure to real estate.

- Foreign exchange risk. As for conventional banks operating in emerging markets, IFIs' exposure to foreign exchange risk can be harmful. While conventional banks can easily hedge themselves through swaps or other hedging instruments, these are generally forbidden in Islamic finance, making the situation more challenging for IFIs. For the time being, this risk is limited for banks operating in GCC states as their currencies are pegged to the dollar (except for Kuwait).

Funding And Liquidity Risk: PSIA's Are A Unique Feature Of Islamic Banks

Liquidity is one of the most critical issues for IFIs, as only a small secondary market exists to enable them to manage their liquidity. Their assets are generally not sellable on a secondary market and they cannot invest in fixed-income instruments for treasury management purposes. This fact is all the more damaging for them as, in the Gulf region, sovereigns have been using local and foreign currency conventional debt as a means of actively managing their financing needs, and non-Islamic banks have been major subscribers as returns have been attractive. A key development in this area has been the formation in Bahrain, in 2002, of the International Islamic Financial Market (IIFM), whose aim is to create and standardize financial instruments to meet the liquidity needs of IFIs around the world. In addition, some leading Islamic banks have set up bilateral agreements with their respective central banks in order to address this weakness. This is notably the case for Al Rajhi Bank, which has an investment portfolio that can be repoed with the Saudi Arabia Monetary Agency (SAMA).

Many Islamic banks offer PSIA's to their customers. These financial instruments are relatively similar to the time deposits of conventional banks. The terms and conditions of PSIA's provide for depositors being entitled to receive a share of the bank's profits, but also obliged to bear potential losses pertaining to their investment in the bank. This profit-sharing principle--according to which investors and entrepreneurs must share the risks and rewards of a given venture--is core to and one of the five pillars of Islamic finance (see appendix). It translates into a displaced commercial risk, however, and could result in a liquidity stress should PSIA holders decide to withdraw their deposits at maturity. This risk could be triggered by the inability of an IFI to provide these depositors with returns that are relatively similar to competitors' (conventional or Islamic). Several layers of protection have been developed by some IFIs, however:

- Profit equalization reserves (PERs). These reserves constituted by IFIs can be used to smooth returns offered to PSIA holders in cases of reduced distributable cash flows. For instance, if an Islamic bank realizes an effective profit that is not sufficient to offer its PSIA holders a satisfactory return, it could use part or all of its PER to boost the return and maintain its deposit base. PERs are deducted from a bank's gross profit before allocating the mudarib fee.
- Mudarib fee. This is the remuneration of the bank for acting as a manager (mudarib) of PSIA's. The mudarib fee is not fixed and differs from one bank to another, but is typically between 20% and 40% of the distributable cash flows. This can provide a bank with some room for maneuver in case of unexpected profitability deterioration; it could simply decide to waive its fee, allowing a higher remuneration to PSIA holders.
- Investment risk reserves (IRRs). These are reserves constituted by IFIs in order to curb the risk of future unexpected losses and enable them to be in a position to support PSIA holders should such losses occur. IRRs are set aside by IFIs after allocating the mudarib fee.
- Liquidity. IFIs offering PSIA's are in general more liquid than conventional banks as they are aware that their reliance on PSIA's could trigger liquidity stress. The average liquid-to-

total assets ratio for GCC-based IFIs rated by Standard & Poor's was 30% at midyear 2007, compared with 18.1% for GCC-based conventional peers. This extra liquidity has a negative impact on profitability, however. Some leading Islamic banks have a portfolio of assets that can be repoed with their central bank.

IFIs can diversify their funding sources through wholesale funds such as sukuk. Issuance of these instruments has increased rapidly over the past three years, reaching almost \$100 billion at Dec. 31, 2007. Sukuk offer a longer term and more stable source of funding. We expect the sukuk market to continue to grow, as IFIs need to increase their stable funding to cope with the opportunities emerging in their markets, notably in mortgage lending.

Other Risks: Typical To IFIs And Equally Important

Reputation risk could arise related to the interpretation of Sharia and differences between fatwa (opinions of Sharia boards regarding the Sharia compliance of specific transactions). As already stated, Standard & Poor's does not provide any opinion on the Sharia compliance of a product or a given financial institution, but the risk of being perceived as non-Sharia compliant could severely damage the creditworthiness of an IFI. For instance, Muslim depositors might withdraw their funds from a bank, triggering a liquidity crisis. Retail customers that are mainly attracted by the Islamic nature of a bank might also stop requesting loans from this institution, triggering a downturn in profitability. Reputation risk can also arise from the perception of a link of an IFI with unlawful financing. In the aftermath of Sept. 11, 2001, IFIs made a lot of investments in their know-your-customer (KYC) systems and anti-money-laundering (AML) procedures in order to curb this risk, however.

The shortage of skilled human resources is becoming a bigger concern for the industry. The strong growth in Islamic finance over the past decade and the creation of new IFIs means that having and maintaining qualified human resources is becoming very challenging. This risk may result in management discontinuity and ultimately damage the creditworthiness of an IFI. On a positive note, we have noticed that some professional "qualifications" in Islamic finance have been created. This should ease the pressure on the industry in the medium term.

Appendix: The Five Pillars Of Islamic Finance

IFIs have to abide by the five pillars of Islamic finance, which are::

- 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.

Sukuk Market Declined Sharply In 2008, But Long-Term Prospects Remain Strong

The sukuk market declined sharply in 2008 as a result of global market turmoil, drying up of liquidity, widening of credit spreads, and investors' wait-and-see attitude. Although difficult to measure, part of this decline could also have been due to comments about the Sharia compliance of some sukuk by the Accounting and Auditing Organization for Islamic Financial Institutions. More than 45% of sukuk issued in 2008 were "ijara" (lease financing), most probably as a direct consequence of the debate about Sharia compliance among some scholars. The value of sukuk issued in 2008 dropped by more than 56% compared with 2007, to \$14.9 billion. Standard & Poor's Ratings Services does not expect the market to start reviving before the second half of 2009 or early 2010.

Standard & Poor's considers that long-term prospects for the sukuk market remain strong, however. Although volumes dropped dramatically in 2008, the sukuk market attracted about the same number of issuers. Conservative estimates of the pipeline of sukuk that have been talked about or announced are in excess of \$45 billion. Several factors support sustainable growth of this market, including increasing popularity of Sharia-compliant products and government openness to Islamic finance, massive investment and financing needs in the Gulf, and issuers' desire to tap investors from the Middle East and Muslim Asia. Issuers from more than 20 countries have expressed interest in issuing, or announced their intention to issue, sukuk, and Standard & Poor's anticipates that several new sovereigns will enter the market.

To date, Standard & Poor's has rated 27 sukuk (or sukuk programs), the bulk of which are ijara or "musharaka" (venture capital financing). (Please see our "Glossary Of Islamic Finance Terms," published Jan. 7, 2008, on RatingsDirect.) Credit spreads on sukuk have followed the same trend as for conventional bonds, with a sharp widening in the past 12 months. The average size of the sukuk issued last year declined significantly, partly due to the lower appetite of investors. At the same time, the U.S. dollar lost its place as the currency of choice for sukuk, with only about 10% of issues raised in this currency. Standard & Poor's expects the sukuk market to continue being skewed toward issuances in local currencies, at least in the foreseeable future. Once global markets return to normal, dollar-denominated sukuk issuance will pick up again.

Growth Will Resume Once Market Conditions Normalize

The sukuk market experienced a dreadful year in 2008, largely as a result of deteriorated global market conditions. For instance, the Gulf Cooperation Council (GCC) countries, one of the two key markets for Islamic finance, experienced a major shift in liquidity flows. The liquidity inflow into the Gulf--mainly into the United Arab Emirates (UAE) and Saudi Arabia--started to reverse from the second half of 2008 when investors betting on the revaluation of the domestic currencies left these markets. This led to a significant downturn in local and regional debt and equity markets, including the sukuk market.

Overall, total sukuk issued globally dropped to \$14.9 billion in 2008 from \$34.3 billion in 2007. Appetite for sukuk declined dramatically, along with that for international debt issuances, loan syndications, and other wholesale debt. We expect the sukuk market to revive only in the second half of 2009 or early 2010 if and when financial market conditions start to improve. This delay is despite the fact that the pipeline for sukuk issuance remains healthy and the market is attracting interest from an increasing number of issuers in both Muslim and non-Muslim countries.

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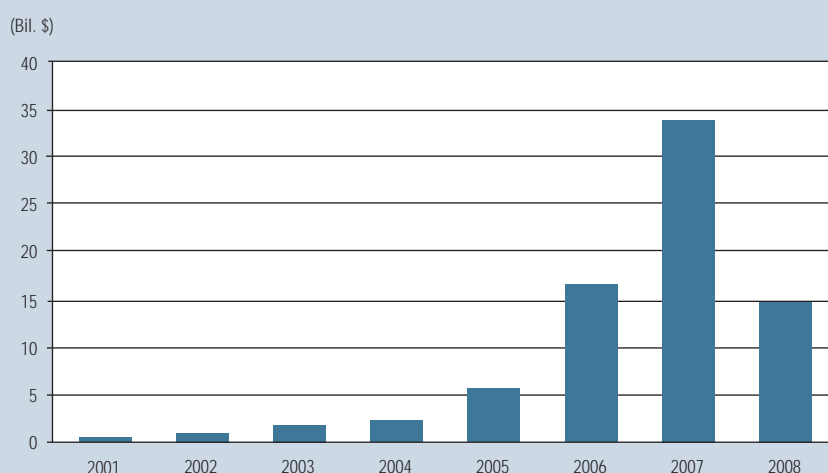
Publication date:
14-Jan-2009

Several structural factors indicate that growth in the longer term should be rapid:

- On the demand side, investors from the Middle East and Muslim Asia are increasingly seeking to invest in products that are compliant with their religious beliefs. In addition, wealth accumulated when oil prices were high in the past few years means that their financial flexibility is still strong.
- On the supply side, massive infrastructure projects in the Gulf require a huge amount of financing. Conventional borrowers are also seeking to diversify their investor base. They want to attract funding from investors as the crisis continues to widen and access to wholesale funding sources remains constrained.
- Governments' and regulators' openness to Islamic finance is increasing around the world. We observe this trend not only in Muslim countries but also in non-Muslim countries such as the United Kingdom (AAA/Stable/A-1+), the European country most supportive of Islamic finance.
- Financial institutions are seeking to better balance their funding, especially in the Gulf where short-term funding sources typically dominate and maturities are increasing on the asset side.

Last year clearly showed that the sukuk market is connected to global debt markets. Islamic finance is one component of global finance and is exposed to the ups and downs of international funding markets. Therefore, we expect the revival of the sukuk market to start more or less at the same time as that of the conventional capital markets.

Chart 1: TOTAL SUKUK ISSUANCE (2001-2008)

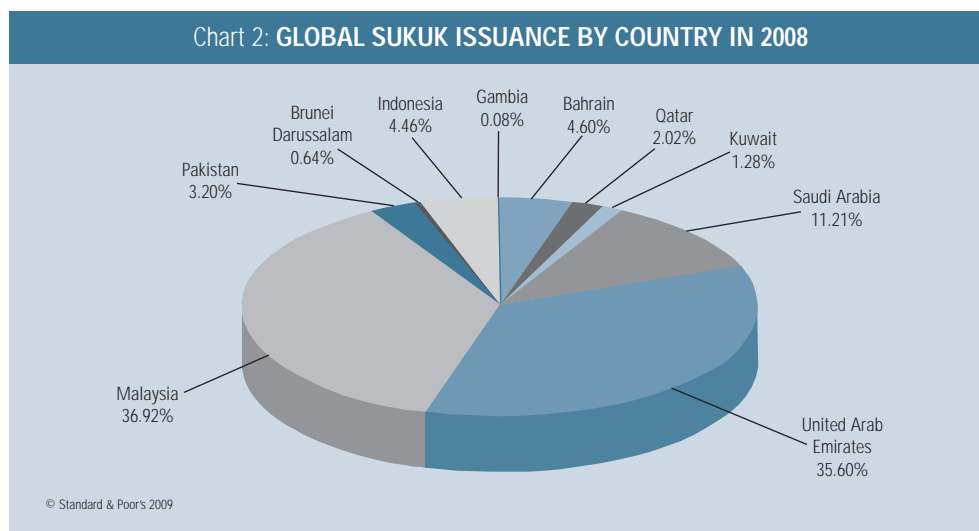


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The Club Of Sukuk Issuers Is Widening

One of the few positive developments for the sukuk market in 2008 has been its continuous geographic diversification. It is attracting issuers from an increasing number of countries and this trend is set to continue. Issuers from more than 20 countries have expressed interest in issuing, or announced their intention to issue, sukuk. Therefore, Standard & Poor's expects the market to continue globalizing.

We expect more sovereign issuers to join the club in 2009. We understand that the Republic of Singapore (AAA/Stable/A-1+), the Republic of Indonesia (local currency BB+/Stable/B; foreign currency BB-/Stable/B), the Republic of Kazakhstan (local currency BBB/Negative/A-3; foreign currency BBB-/Negative/A-3), and the State of Qatar (AA-/Stable/A-1+), among others, plan to issue sukuk. Sovereign issuances should support the construction of a yield curve and introduce benchmarks for private issuers in these countries, boosting the growth of the sukuk market.



Malaysian and UAE-based issuers continued to drive the sukuk market, with more than 70% of total issuance coming from these two countries in 2008. Authorities' support for Islamic finance and openness to foreign investors are the key elements behind these figures. Other GCC and Asian countries are set to increase their contribution to the growth of the market in the future thanks to huge financing and investment needs in the GCC, as well as sovereign issuance and support for Islamic finance development.

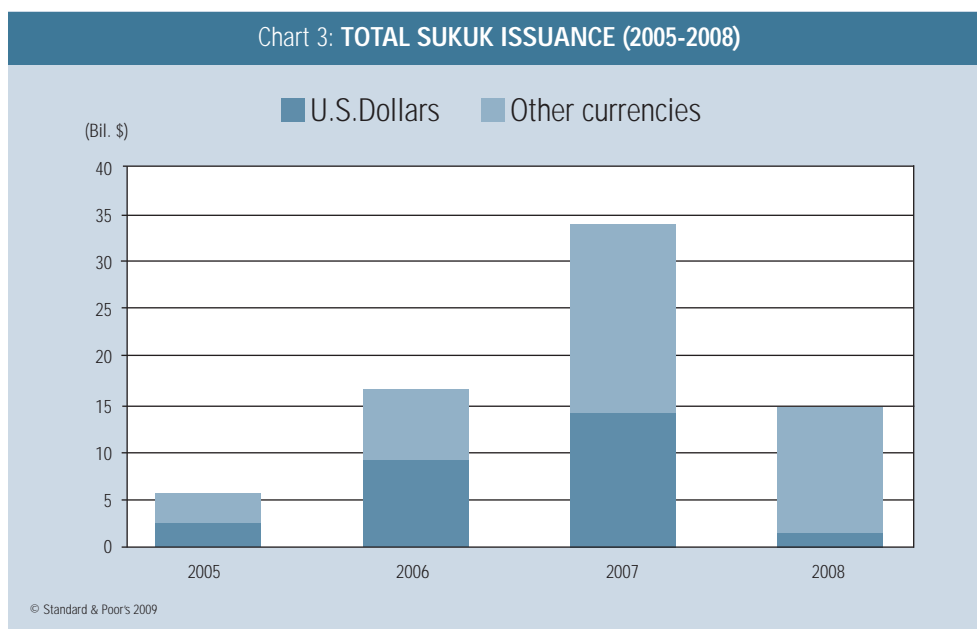
In 2008, the largest sukuk was issued out of Saudi Arabia by Saudi Basic Industries Corp. (SABIC, A+/Stable/A-1) for a total amount of Saudi Arabian riyal 5 billion (\$1.3 billion). The structure of this sukuk was very innovative. Under an asset transfer agreement, SABIC transferred certain rights and obligations for specific marketing agreements to SABIC Sukuk LLC, a 100% subsidiary. These represent SABIC Sukuk LLC's underlying assets, and it will hold them as a custodian for the benefit of the sukuk holders. The sukuk assets should generate the necessary cash flows to cover periodic payments to the sukuk holders. SABIC will be required to purchase the sukuk from the sukuk holders when they exercise their right to redeem their sukuk. Therefore, we have equalized the ratings on the sukuk with those on SABIC.

The other large sukuk, denominated in local currency, were issued out of the UAE, by Aldar Properties PJSC (A-/Stable/A-2), Nakheel PJSC, Dubai Electricity and Water Authority, and Sorouh Abu Dhabi Real Estate LLC. The sukuk issued by Sorouh (Sun Finance Ltd. Class A, B, and C) was the first sukuk with no credit enhancement that we have rated. We believe that the potential for asset-backed sukuk continues to be strong despite the currently weak investor interest in structured products.

U.S. Dollar Is No Longer The Currency Of Choice For Sukuk Issuance

The U.S. dollar lost its leadership position in sukuk issuance in 2008, with only about 10% of issuance in this currency. The credit crisis meant that sukuk issuers had to attract domestic investors instead of international investors. Issuers deserted international markets and concentrated on local markets where liquidity was more abundant and the appetite for Sharia-compliant instruments stronger. In addition, investors betting that some GCC governments would de-peg their currencies from the dollar converted their funds into local currencies and placed them on local and regional debt and capital markets. In the end, the governments did not de-peg their currencies, however, and currently five out of the six GCC countries' currencies are pegged to the U.S. dollar. Standard & Poor's expects the sukuk market to continue being skewed toward issuance in local currencies in the foreseeable future, with only a limited portion being issued in dollars. Some of the sovereign sukuk to be issued in 2009 or 2010 will be both in local and foreign currencies (mainly the U.S. dollar). Once market conditions return to normal, dollar-denominated sukuk will regain a stronger position, however.

Chart 3: TOTAL SUKUK ISSUANCE (2005-2008)



Standard & Poor's Role In The Market For Sukuk

Our role is to provide market participants with independent and objective opinions about the creditworthiness of issuers and issues—including those involving sukuk. We don't comment on the Sharia compliance of a particular issue or issuer. Our ratings don't constitute a recommendation to sell, buy, or hold a particular security--whether it is Sharia compliant or not. Instead, our ratings help investors to make informed decisions and issuers to access debt markets and benchmark their creditworthiness against peers'.

Islamic Sukuk Come Of Age In Infrastructure And Project Finance

Sukuk transactions, including nonrecourse financings, appear to be gaining traction in the Gulf region for project and infrastructure funding as investors become familiar with their features and flexibility. While the global economic slowdown may have curtailed the uptake of these transactions for now, investor appetite should recover in line with the business cycle. At the same time, however, the continued success of project and infrastructure sukuk will in Standard & Poor's Ratings Services' opinion require the resolution of outstanding compliance and security related issues.

In the time since we last reported on our rated infrastructure and project finance sukuk (see article titled "Credit FAQ: Project Finance Sukuk," published Nov. 16, 2007, on RatingsDirect), we have assigned a rating to the Tabreed 08 Financing Corp. convertible sukuk. This transaction features sharia-compliant trust certificates that are mandatorily exchangeable into ordinary shares of National Central Cooling Co. PJSC (Tabreed; BB/Developing/--). We've also rated Sun Finance Ltd. (a United Arab Emirates {UAE} dirham based securitization of receivables from the sale of plots of land on the Shams Abu Dhabi development on Al Reem Island).

These transactions notwithstanding, project and infrastructure sukuk issuance in the Gulf has stalled. After years of rapid growth, the past few quarters have been difficult in the Gulf Cooperation Council (GCC) states and the project and infrastructure sukuk markets have not grown in 2008 to the levels anticipated. Nevertheless, the Tabreed 08 and Sun Finance issues may provide a basis for future infrastructure and project finance sukuk.

Global Slowdown And Local Factors Crimp Sukuk Issuance

The market's anticipated growth of sukuk (including those for infrastructure and project finance) failed to materialize in 2008, total sukuk issuance falling 56% to \$14.9 billion compared with the previous year. That said, the value of Standard and Poor's rated project and infrastructure sukuk was broadly similar in both 2007 and 2008.

We believe that the underperformance in sukuk issuance is due in large part to the effects of the global economic downturn, specifically its influence on capital market issuance in GCC states. We are of the view, however, that notwithstanding the current state of the financial markets, the GCC will be the focus of most infrastructure and project finance sukuk activity in the short to medium term. This is because sukuk funding structures provide an alternative to the traditional bank financing that shows no immediate signs of return in the currently dislocated financial markets.

Local factors curb investor appetite for sukuk

The effects of the global downturn aside, the GCC region has its own contributing macroeconomic factors that continue to affect project and infrastructure sukuk issuance, namely:

High costs of financing.

In our experience, the costs of structuring and issuing sukuk remain high relative to conventional bank loans and bond issuance. Legal and accounting fees contribute to this higher cost structure, as does uncertainty regarding the perceived risk associated with

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Publication date:
20-April-2009

these instruments. Moreover, the lack of standard structures, perceived differences in approach to sharia compliance, and a relatively illiquid secondary market may, in our view, discourage investor appetite for sukuk.

Predominantly local investor appeal.

In 2006 and 2007, there were a number of sukuk placed with international investors, including those of DP World Ltd. (A/Negative/A-1) and Tabreed. In 2008, by contrast, the reduced appetite for sukuk saw many issues taken up by local investors and denominated in local currencies. Furthermore, foreign currency-denominated, cross-border-placed sukuk remain more expensive than their locally placed counterparts. This is due to withholding tax payments applicable to cross-border transactions, on which investors demand a compensating coupon. Finally, we understand that uncertainty over the prevalent practice of pegging GCC state currencies to the U.S. dollar may also make foreign-currency denominated sukuk less attractive than those issued locally. As a consequence, local currency sukuk have been dominant. The relative degree of liquidity tightening in these local markets compared with levels a year earlier also contributed to funding costs.

Real estate downturn.

The correction in UAE real estate markets, particularly in Dubai in the second half of 2008, suggests that government-related developers, utilities, and infrastructure companies reliant on third-party construction might be revising their financial and business models to reflect new market circumstances. This, in turn, suggests that funding of discretionary capital expenditures in the second half of 2008 through sukuk issues is likely to have been indirectly affected.

Hydrocarbon prices.

The reduction in oil prices from around \$128 per barrel at the end of June 2008 to around \$40 per barrel at the end of December has, in our view, dampened wealth expectations in the GCC. This, in turn, has likely affected expansion plans for government entities by placing more scrutiny on the projects that should progress. Cheaper oil prices may have also affected local issuer and investor appetite for infrastructure and project finance sukuk.

Accounting issues.

In our view, the February 2008 announcement by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), which addressed the issue of whether bonds structured with no transfer of collateral were sharia-compliant, contributed to market uncertainty. We understand anecdotally that the AAOIFI's position may have prompted investors to seek a "risk premium" for particular sukuk transactions and, consequently, to a lull in issuance. We are not aware of any subsequent action taken by the AAOFI.

Despite these developments, high-profile sukuk issuance continues in the region. Both the Saudi Electricity Co. and Dubai Electricity and Water Authority issued sukuk in late 2007 and during 2008 to fund capital expansion in Saudi Arabia and Dubai, respectively. Sukuk-based financing remains the most attractive means of raising funding for medium- and long-term capital costs for GCC issuers. It forms the basis of a number of high-profile, hydrocarbon-related GCC project transactions, often split equally with debt-based bond and bank financing. As the Islamic infrastructure and project finance market develops, we anticipate there will be more transactions funded exclusively by sharia-complaint means.

The Sukuk Instrument Proves Adaptable

In our opinion, sukuk have proven adaptable to complex infrastructure financings, as evidenced in the Tabreed 08 and Sun Finance projects.

It's our understanding that one of the purposes of the Tabreed 08 sukuk, for instance, was to raise financing for Tabreed's capital facilities expansion without increasing leverage. Tabreed 08 issued nondeferrable, deeply subordinated, and mandatory convertible ijara sukuk notes. In practice, annual profits are distributed to Tabreed 08, which services the notes over three years prior to conversion. Principal and interest payments are subordinated to all of the parent company's other debt obligations (unless expressly qualified as more junior) and ranked at the time of issuance senior only to common shares. Although the Tabreed 08 notes have sufficient debt-like characteristics to enable them to be rated, Standard & Poor's treats the principal amount of the notes as equity in order to calculate Tabreed's financial ratios. Similarly, we treat coupon payments as dividends for the purpose of our analysis. Since the Tabreed 08 issue, we have also rated convertible notes issued by Abu Dhabi National Energy Company PJSC (TAQA; AA-/Stable/A-1+). However, these were not structured as Islamic convertible notes.

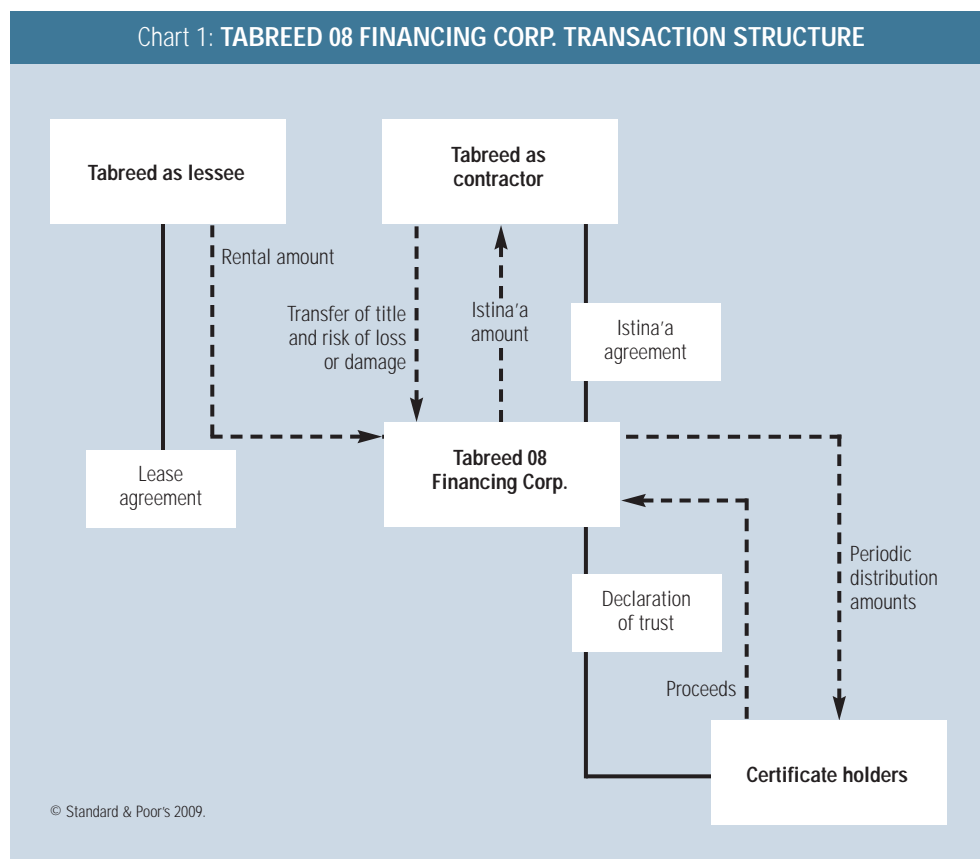
We believe that once conditions improve in the financial markets, infrastructure developers seeking high equity treatment for capital market issuance may continue to employ sharia-compliant convertible notes to fund their capital needs. As we discuss below, Sun Finance, a construction financing backed by property receivables, has in our opinion already helped to extend the boundaries of nonrecourse project and infrastructure sukuk financings.

Recent Transactions Point The Way Forward

Our analytical approach to rating infrastructure and project finance sukuk is illustrated in the following transactions:

Tabreed 08 Financing Corp.

Tabreed 08 is a special purpose entity wholly owned by Tabreed. Its sukuk issuance is being used to fund the construction of district cooling plants. The structure of this transaction makes use of both an ijara (sale and leaseback) and istisna (construction and delivery) agreement (see chart 1). In fact, the Tabreed 08 structure resembles that of the Tabreed 06 Financing Corp. senior secured sukuk that we rated in June 2006, although there are some important differences.



At closing, Tabreed 08 purchased the cooling plants (or a part thereof) from Tabreed and entered into a lease arrangement, with Tabreed as lessee. Tabreed distributes annual profits (lease payments) to the issuer. Those monies are used by the issuer to service the coupon payments on the notes over the first three years. The proceeds of the sukuk issuance fund construction of the plants, while Tabreed will buy back the cooling plants from Tabreed 08 at maturity at a price payable in Tabreed shares, hence the convertible nature of the instrument.

By contrast, in the Tabreed 06 transaction Tabreed will buy the cooling plants through exercising the purchase undertaking that in turn ultimately redeems the notes.

The following points of comparison exist between the “debt-like” features of the Tabreed 06 sukuk and the “equity-like” features of the Tabreed 08 sukuk:

- Under the Tabreed 08 sukuk, all lease payments are subordinated under normal circumstances to other senior creditors of Tabreed, as well as in the event of a payment default. This subordination of the Tabreed 08 sukuk.
- Under the Tabreed 08 sukuk, consistent with its equity-like characteristics, lease payments service only the sukuk coupon, not principal. This contrasts with the Tabreed 06 senior sukuk purchase mechanism, which provides for payment of interest and principal on maturity via exercise of the purchase undertaking.

Standard & Poor's assigns a high equity content to the Tabreed 08 notes for three main reasons: They mandatorily convert into ordinary shares of Tabreed in three years; coupon payments are generally subordinated to Tabreed's other debt obligations; and the notes currently rank senior only to common shares. The notes were originally rated two notches lower than the long-term corporate credit rating on Tabreed. This is because of their

subordination and to reflect the market risk resulting from the relative evolution of the share price and of the conversion ratio of the notes.

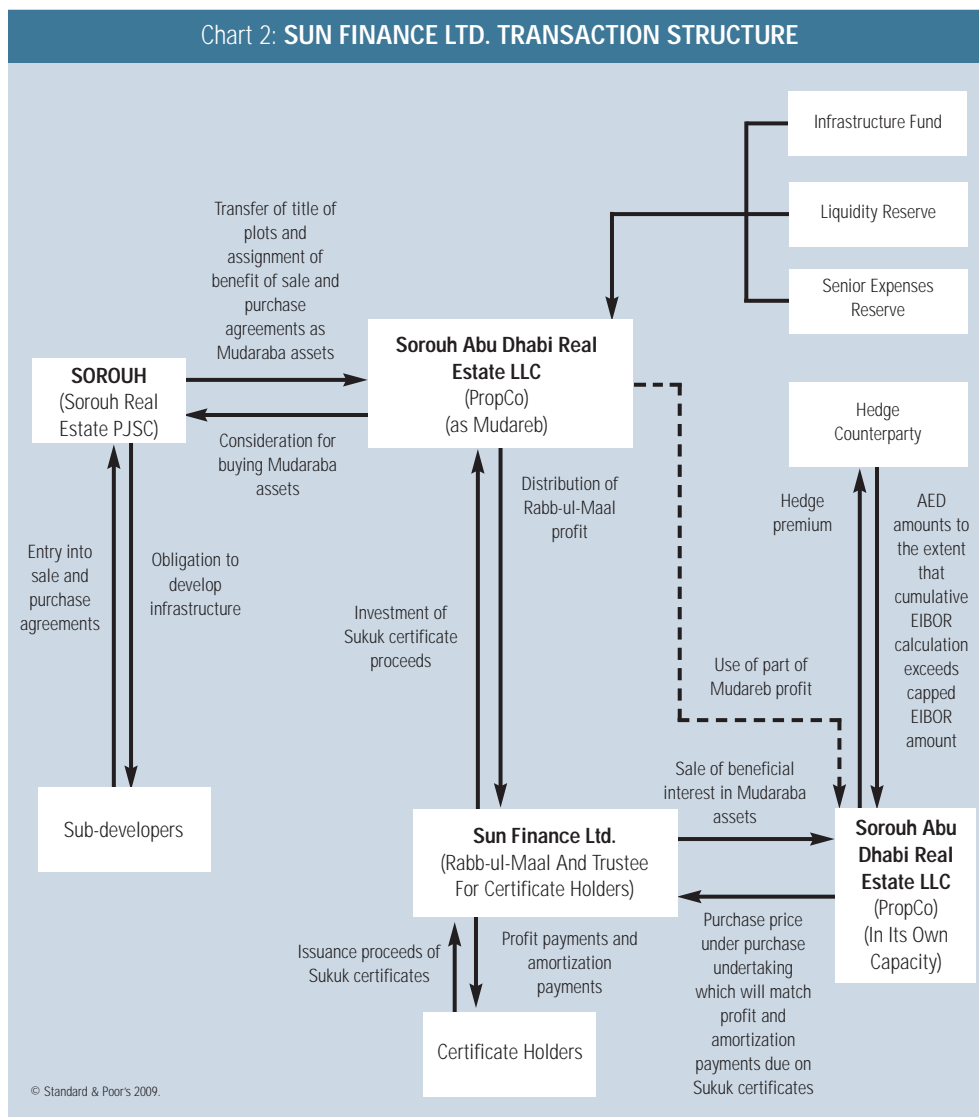
Since the ratings were assigned on April 14, 2008, the long-term rating on Tabreed has been lowered to 'BB' with a developing outlook. Following the downgrade in December 2008, we increased the differential between Tabreed's long-term rating and the Tabreed 08 convertible notes to three notches from two to reflect the latter's lower recovery potential.

Sun Finance Ltd.

The purpose of the Sun Finance securitization is to allow Sorouh Real Estate PJSC (Sorouh; not rated) to monetize future cash flows for from the sale of real estate plots to property developers. Sorouh applied the proceeds of the monetization toward funding the utility infrastructure for two sites. One is Shams Abu Dhabi, a 170-hectare development on Al Reem Island, and the other is the Saraya development in Abu Dhabi's central business district.

In essence, there are three principle parties involved in this transaction: Sorouh, a project developer that sells the plots; Sorouh Abu Dhabi Real Estate LLC (Propco), that purchases the plots and, in turn, sells them to individual developers; and Sun Finance (Issuer) that issues the Al-Mudaraba Al-Muqayyada certificates to investors.

Chart 2: SUN FINANCE LTD. TRANSACTION STRUCTURE



The transaction is capitalized by Sun Finance applying the certificate proceeds toward a mudareb (investor of capital). The certificate proceeds amount to the Issuer's beneficial interest in the mudareb. Propco, effectively a partner in the mudareb, buys the plots from Sorouh, sells them to the developers, and puts the purchase price toward the investors' (that is, trust certificate holders') returns and funding for the infrastructure works.

As payments from the developers come in through plot sales, ownership of the land incrementally shifts to the developers. In turn, Propco incrementally purchases the Issuer's beneficial interest in the mudaraba (trust) as it receives funds from plot sales, thereby amortizing the certificates (see chart 2). When a plot sale payment is received, Propco releases the relevant plot to the developer.

The Sun Finance transaction shares similarities with the DP World transaction. In that transaction, cash flow movement occurs in the following manner: First, investors pay the issue price for the sukuk and Dubai World Sukuk Ltd. (in its capacity as rab el-maal, or provider of capital) applies the proceeds as the capital of the mudareba, pursuant to a mudareba agreement entered into between the issuer and DP World (the latter acting in its capacity as the mudareb). Second, the mudareb invests the capital of the mudareba in DP World's business activities, in accordance with an agreed sharia-compliant investment plan prepared by the mudareb. The plan is designed to generate "profits," which will be used to service the notes. If insufficient profit is generated, DP World (in its capacity as mudareb) will be required to provide sharia-compliant funding to meet the payments in full.

The basis of repayment is the "profit" generated by the mudareba (or joint investment trust). If the mudareba does not generate enough "profit," DP World is required to provide funds to meet the shortfall in returns generated by the mudareba. DP World does this by exercising the purchase undertaking. For this reason, credit risk is linked not only to the mudareba, but also to DP World.

In comparing the Sun Finance and DP World transactions, we make several observations. One observation is that should DP World prove unable to generate sufficient profits to service the certificates, certificate holders have recourse to a purchase undertaking by DP World for the amounts due under the certificates. Therefore, the rating on the transaction is constrained by the rating on DP World. In Sun Finance, the Propco purchase undertaking is backed solely by the sale proceeds from the real estate plots. If plots are not sold or purchase prices not achieved, Propco will likely not be in a position to meet its obligations under the purchase undertaking. The Issuer's ability to service the certificates lies ultimately in the ability of Propco to sell and be paid for the plots. The significance of this feature is that the credit quality of Sorouh is effectively not an issue once the sale of the plots to Propco is completed, effectively making the Sun Finance transaction a nonrecourse sukuk.

Sun Finance features both senior and subordinated certificates. Standard & Poor's notes that the structure benefits from a fatw'a to the effect that it's sharia-compliant, although we do not verify shariah compliance.

The structure of the Sun Finance transaction reflects certain aspects of our project finance criteria. That said, we do not view it as a traditional project financing. This is because the transaction has much in common with structured financings such as residential mortgage-backed securitizations and corporate securitizations.

Differences between the Sun Finance transaction and more traditional types of project financing include the nature of the special purpose entity, attributes of the Issuer, the security structure, and payment flows.

Propco is 99%-owned by the chairman and managing director of Sorouh, the remaining 1% being held by an independent director. In the event of a payment default by Sorouh, transaction documentation indicates that the 99% share would be transferred to the independent director, who would then own 100% of Propco. Based on the information

available, Standard & Poor's takes comfort that this structure is enforceable under applicable law.

As with the DP World transaction, investors do not have security as much as they hold a beneficial ownership interest in the mudareb. We understand that such interest is not the same as outright legal ownership. While the Issuer has a fixed and floating charge under U.K. law over the assets of Propco, there is some question as to whether such charge would be enforceable in the UAE where the assets are located. In practice, we believe that the fixed and floating charge would likely only provide lenders with recourse to offshore assets of Propco. As noted above, in the event of the insolvency of Sorouh, the issuer is entitled to instruct the independent director to force a sale of the assets held by Propco. In summary, there is a degree of legal and country risk in each transaction.

Finally, in the Sun Finance transaction, the plots are not sold to the Issuer but to Propco. On a plot sale, the Issuer is paid through an onshore cash management agreement. Typically, offshore accounts are established where sale proceeds are deposited. Payments are made from such accounts to investors and back onshore.

Standard & Poor's ratings on structures such as Sun Finance and DP World rely on the economic fundamentals of such transactions as well as their structural and legal aspects.

Will Sukuk Flexibility Lead To Greater Take-Up In The Future?

In 2008, the project and infrastructure asset class accounted for around \$1.6 billion (10%) of the \$14.9 billion of sukuk issues that came to market. In 2009, the development of the sukuk market will depend on economic recovery, increases in oil and gas prices, and the stabilization of real estate markets in the GCC.

In our opinion, there are four important considerations that need to be addressed for sukuk financing to become a major component of project and infrastructure funding in the Gulf as well as in other markets such as Malaysia, Indonesia, Pakistan, and Gambia:

- Greater clarity in transaction structures. Improved documentation, increased standardization, and lower overall complexity;
- Consensus among Islamic scholars around the world, including better issuer and investor education about sukuk and sharia compliance generally;
- A liquid secondary market; and
- A more predictable legal framework. There is a lack of clarity of local law in a number of markets where sukuk issuance is prevalent. In particular, we consider that there are issues surrounding the enforceability of collateral.

Infrastructure financing needs remain significant in GCC states. According to The Middle East Economic Digest, about \$2 trillion of planned and anticipated project and infrastructure financings will be undertaken in the region by 2020. Meanwhile, there remains the more immediate concern of refinancing existing bank loans, which may prove difficult given the reduced appetite for bank lending.

Many of the principles inherent in project financings are found in Islamic finance transactions. Consequently, as project financing matures as an asset class in the Gulf, we believe Islamic finance will continue to adapt to traditional project structures. Similarly, we see Islamic finance structures being applied to public-private partnerships, and independent water and power projects as these programs evolve in the Middle East.

We believe that the use of nonrecourse finance vehicles may continue to be used in securitizing future payment streams and providing short-term liquidity. We observe that securitization and monetization structures are assisting developers such as Sorouh in removing the immediate debt burden of such financings off their balance sheets. However,

there's no track record of sukuk enforcements to date, and the issue of effective legal ownership of assets between a company and its related sovereign have yet to be tested.

In fact, the first infrastructure sukuks rated by Standard & Poor's such as Tabreed 06 and Tabreed 08, are more akin to corporate financing rather than project financing. Furthermore, on a corporate basis it's unlikely that there would be a significant difference in the risk component between a sukuk and secured corporate lending, assuming that the same underlying assets constitute security under the two different issues. It's possible, however, that by having less off-balance-sheet and derivative type counterparty risks, a sukuk transaction could be considered less exposed than a secured transaction with the same underlying assets.

Ultimately, the flexibility of the sukuk instrument may hold key to it increasing its share in financial markets. Although most sukuk issues so far have been debt-like, their ability to be structured as an equity instrument through convertibility means they could access a much wider investor base than traditional loan financing.

Standard & Poor's Approach To Rating Sukuk

Executive Summary

An unprecedented surge in sukuk issuance during the past three years has provided different categories of issuers--sovereigns, corporations, and banks--with an alternative way to structure their funding. Standard & Poor's Ratings Services estimates sukuk outstanding worldwide to be in excess of \$76 billion at yearend 2008. Over two-thirds are unlisted, over-the-counter instruments, with the remainder listed. The number and size of listed sukuk are increasing fast, the largest being that issued by Dubai-based Nakheel Group in early 2007 for \$3.52 billion, listed in London and Dubai. As of yearend 2008, we rated about \$20 billion in sukuk outstanding listed on the world's markets, and we believe the volume of rated sukuk is set to rise due to the rapid development of this type of financing.

Through our rating of Sharia-compliant issuers and issues over a number of years, we believe we have demonstrated a deep and global understanding of Islamic finance. Standard & Poor's understands that in structuring sukuk, parties endeavor to ensure that:

- Rights and obligations of both the issuer and investors are clear and transparent, in compliance with the principle of Islamic finance that bans "gharar" (uncertainty);
- Income from securities is related to the purpose of the funding, and does not simply comprise interest payments--abiding by the principle that bans "riba" (usury or interest); and
- Securities issued are backed by yields derived from identified tangible underlying assets, according to the principle that all financial transactions must be asset backed, or at least asset based.

In light of these principles, sukuk lie on a continuum ranging from the lowest profit-sharing structures (typically guaranteed sukuk with a predetermined rate of profit ranking pari passu with the obligor's other obligations) to the highest profit-sharing structures (nonguaranteed sukuk behaving like ABS and issued by pass-through or pay-through vehicles.) In Arabic, "sukuk" is the plural, generic term for "notes," "certificates," or "bonds." In practice, the market now commonly uses the term generically to refer to debt instruments compliant with Sharia, or Islamic law. In this report, we identify three broad categories of sukuk, and describe our ratings approach for each.

Standard & Poor's Approach To Rating Sukuk Summarized

Our ratings are an opinion about the ability and willingness of an issuer to meet financial obligations in a timely manner, without commenting on Sharia compliance. The rating on an Islamic debt instrument varies depending on the degree of performance risk of the asset backing the transaction. Depending on the collateral type and transaction structure, the issue rating may be higher than the senior unsecured rating on the obligor.

There are various ways to structure sukuk: the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) lists 14 structures. In practice though, issuers have made use of only a handful of sukuk structures, including "ijara" (lease-back) deals and "musharaka" (co-ownership) contracts.

Notwithstanding the potential variety of sukuk structures, we group them into three broad categories:

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Publication date:
17-Sep-2007

Sukuk with full credit-enhancement mechanisms

Under this structure, sukuk receive an irrevocable third-party guarantee, usually by a parent or original owner of the underlying collateral. The guarantor provides Sharia-compliant shortfall amounts in case the issuing vehicle (usually a special-purpose entity or SPE) cannot make payment. The ratings on this type of sukuk are largely dependent on the creditworthiness of the guarantor or the entity providing the credit enhancement mechanisms, as well as the ranking of the sukuk (usually senior unsecured) among other financial obligations of the guarantor.

Sukuk with no credit-enhancement mechanisms

Under this structure, sukuk resemble ABS in a securitization. The pool of underlying assets serves as the sole basis for coupon and principal payment. The ratings on these sukuk are largely based on the ability of the underlying assets to generate sufficient cash to meet, in a timely manner, the SPE's obligations. Standard & Poor's ratings, in this particular case, are based on the performance of the underlying assets under different stress scenarios along with the expected value of these assets at maturity.

Sukuk with partial credit-enhancement mechanisms

This structure combines features of both of the first two categories, with a third-party guarantee absorbing limited shortfalls from an otherwise asset-backed transaction. Our ratings approach depends on our estimate of the capacity of the underlying assets to meet the SPE's financial obligations as well as the terms of the guarantee and the creditworthiness of the guarantor.

To date, Standard & Poor's has assigned ratings to 23 sukuk issued by sovereigns, supranationals, regional governments, corporations, and financial institutions. Most sukuk we rate benefit from full external guarantees, falling in the first category. We therefore have assigned them ratings equivalent to those on their guarantors and view them as ranking *pari passu* with the senior unsecured obligations of guarantors.

In the longer term, we foresee increasing issuance of more complex sukuk with no credit enhancement mechanisms, which would fall into the second category. More generally, we expect securitization, particularly in the Middle East, to increase and to take the form of Sharia-compliant structured transactions, giving rise to asset-backed sukuk notes with limited or no guarantee from the asset originator. The tranching of liabilities, a conventional securitization tool, is still under discussion among Sharia scholars regarding compliance, although a few tranching mortgage-backed sukuk have already been issued in Malaysia and the Gulf region, as well as asset-based subordinated sukuk.

Rating Sukuk With Full Credit-Enhancement Mechanisms: The Most Common Type of Rated Sukuk

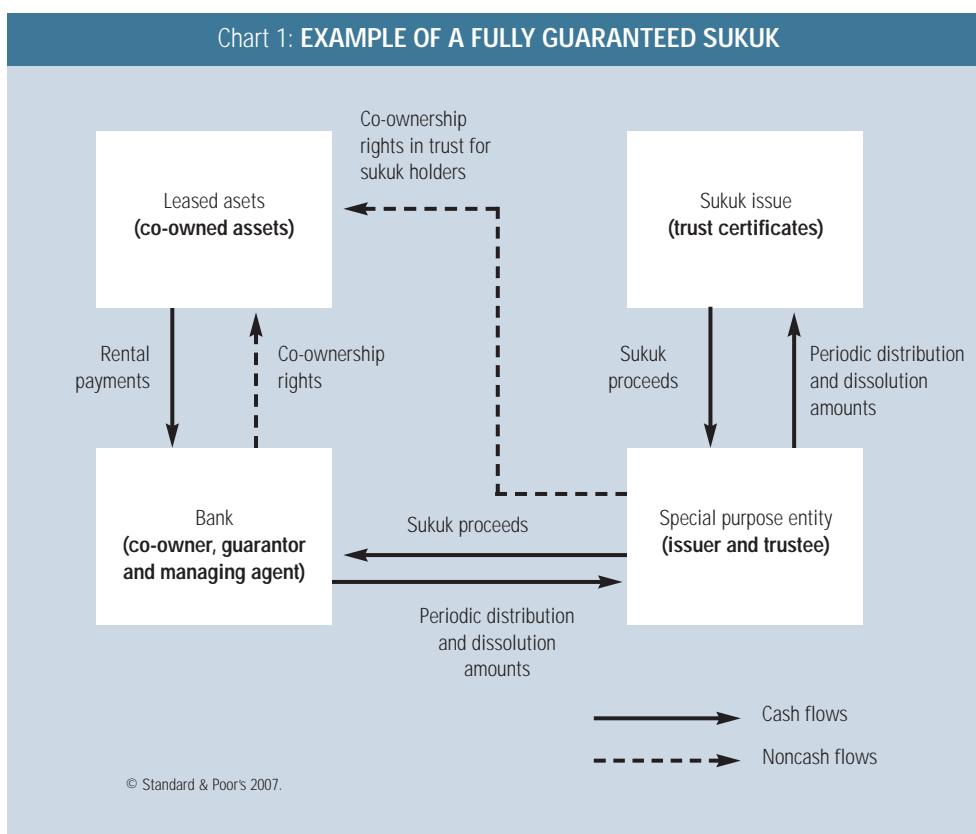
Among credit-enhanced or guaranteed sukuk, Standard & Poor's rates "istisna" (project,) "mudharaba" (trust financing,) "musharaka" (co-ownership,) and "ijara" (leasing) structures. Ijara contracts so far have been the most popular form of sovereign-issued sukuk. For banks, musharaka contracts have been the most widely used and preferred route for issuing sukuk, as Islamic banks have only limited ownership of income-generating tangible assets to lease and lease back. Banks have therefore chosen to sell part of their credit and/or investment portfolios for the purpose of issuing sukuk. Usually, the seller of the underlying assets (the originator of these assets and guarantor) is also the manager or servicer.

In rating guaranteed sukuk, we base our assessment on the creditworthiness of the guarantor. The guarantee covers not only the principal amount of the sukuk payable at the maturity date or in the case of predefined default events, but also the periodic payments

(coupons) from the SPE to sukuk holders. One of the most important factors in assigning ratings in this sukuk category is the level of seniority of the originator's guarantee and, more precisely, whether it ranks pari passu with all other similar obligations of the guarantor.

Example of fully guaranteed sukuk: sukuk al musharaka (co-ownership) issued by a bank

The transaction structure involves an SPE issuing musharaka sukuk. The proceeds of the sukuk will ultimately be used for a specific or general purpose by the bank, which sells a given percentage of a pool of assets to the issuer. These assets, originated, leased, and managed by the bank, are co-owned by both the bank and the issuer. The latter holds a given percentage of the co-owned assets in a trust capacity for the benefit of sukuk holders, owing to the proceeds received from the issuance of the trust certificates, and for a period of time corresponding to the duration of the sukuk. The pool of co-owned assets is in this case made up of leasing (ijara) contracts between the bank and its customers, pertaining to residential properties and other assets. The lease rental payments on the co-owned assets are collected by the bank as the managing agent of the assets, and serve as the basis for the floating periodic distribution payments payable on the trust certificates. On dissolution of the trust, the bank is to purchase the portion of the co-owned assets held by the issuer at the agreed exercise price, which will fund the dissolution distribution amount that is payable to the certificate holders and is equal to the principal of the sukuk (see chart 1).



The guarantee of the bank--simultaneously originator, managing agent, and guarantor--is the most important rating factor. The rating on the sukuk is equalized with our rating on senior unsecured debt of the bank, as guarantor. The equalization reflects the bank's obligation to make up for any shortfall if rental payments from the co-owned assets are insufficient to make the coupon payments. This obligation ranks pari passu with all other unsecured and unsubordinated obligations of the bank as guarantor. The dissolution amount payable on the trust certificates at the dissolution date is also dependent on an obligation of the bank. This

obligation is the irrevocable undertaking of the bank to purchase the issuer's portion of the co-owned assets at the agreed price. This structure was used by United Arab Emirates-based Sharjah Islamic Bank (BBB/Stable/A-2) for its five-year \$255 million sukuk issued in 2006.

Rating Sukuk With No Credit-Enhancement Mechanisms: Less Common, But Expected To Emerge In The Future

The rating on this kind of sukuk would depend primarily on the ability of the underlying assets to generate enough cash flow to meet all of the issuer's financial obligations in a timely manner. In other words, the rating would depend mainly on the nature of the underlying assets. For example, if the underlying asset is a project, we would use our project finance methodology to estimate the value of the project and its ability to generate a sufficient amount of cash to pay the periodic installments and final principal repayment. Ratings on this kind of sukuk could be higher or lower than the ratings on the originator. We expect that this type of sukuk will become more popular in the foreseeable future in response to the huge number of projects in the planning stage, particularly in Gulf countries.

Changes to regulation in the Gulf could give a boost to this type of sukuk. Banks and regulators in the Gulf are currently considering enhancing the legal framework surrounding mortgage financing for both commercial and residential properties. In the longer run, once sufficient mortgage loan volumes are booked on banks' balance sheets, Islamic securitization will become more attractive. Given their quality, which can be tracked statistically, and high granularity, mortgage loan portfolios would become good candidates for asset-backing the issuance of nonguaranteed sukuk. Residential and commercial mortgage-backed sukuk have been so far limited in number; the most recent was Cagamas MBS Berhad's Malaysian ringgit (MYR) 2.11 billion Islamic RMBS issued in Malaysia in May 2007. Both conventional and Islamic financial institutions might increasingly turn to this category of sukuk in the future, especially if portfolios are built on a larger scale; credit information pertaining to them is collected, stored, and documented; and the underlying legal framework is supportive, particularly of the legal isolation of assets for the benefit of investors.

In rating this type of sukuk, we would likely focus on: (1) the ability of the underlying assets to generate enough cash to meet the SPE's sukuk payment obligations; (2) the capacity of the managing agent (often called "mudarib") to act as servicer and transfer payment from the obligors to the "rab el-maal" (investors); and (3) the expected value of the reinvested cash flows, compared with the principal amount of the sukuk. We would subject these three key elements to thorough analysis, based on modeling the behavior of the underlying mortgages and liquid instruments under different possible stress scenarios, as well as on documented assumptions about the recovery rates of the securitized asset classes. As for any other credit rating, we would also examine the supportiveness of the underlying legal framework, especially legal isolation of the assets from the originator's insolvency.

Rating Sukuk With Partial Credit-Enhancement Mechanisms: Requiring A Case-By-Case Approach Encompassing A Wider Range Of Analytical Steps

Partially credit-enhanced sukuk benefit from a third-party guarantee with respect to either periodic profit distributions or the principal amount, but not both. We see the partial guarantee as a mechanism enhancing the creditworthiness of the sukuk, but as such not providing enough for us to equalize the rating on the sukuk with that on the guarantor.

Our rating approach for this type of sukuk is therefore based on two elements:

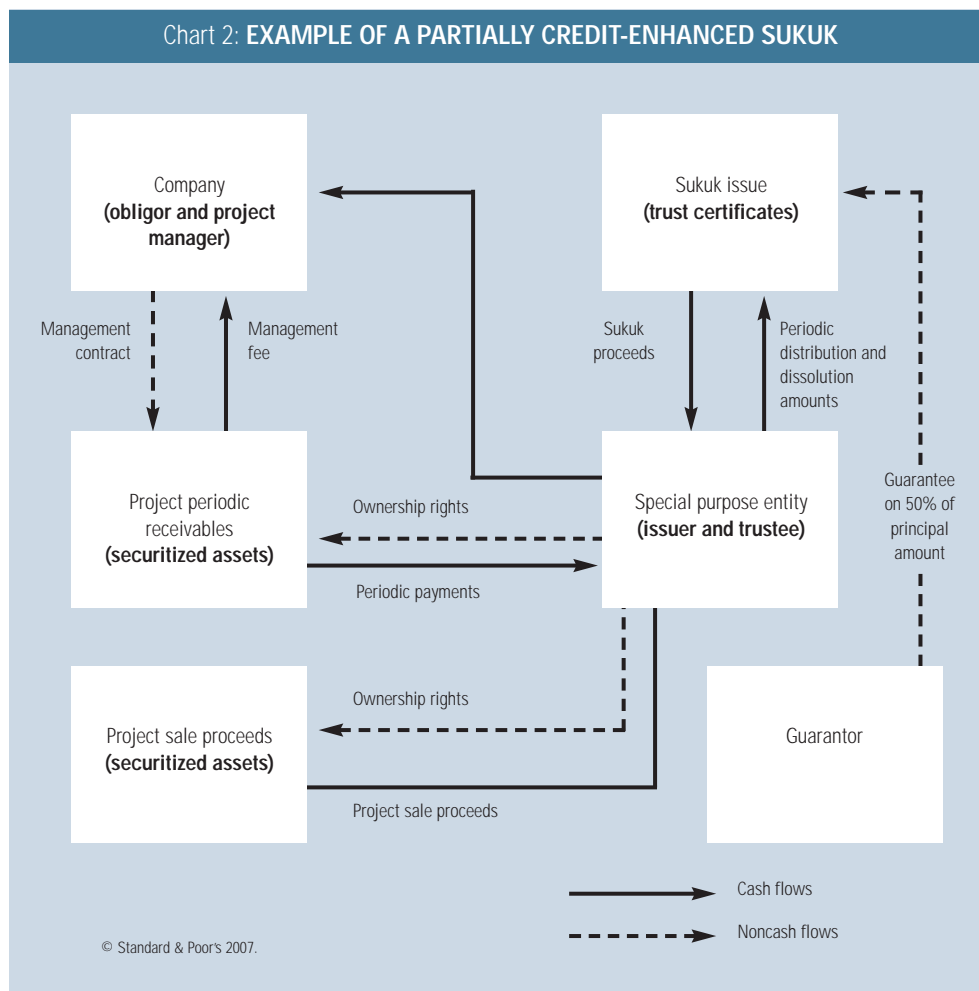
- An assessment of the overall creditworthiness of the sukuk on a stand-alone basis, which means an evaluation of the ability of the underlying assets to generate sufficient cash flow to allow the issuing SPE to meet its financial obligations. This step is similar to our approach in rating nonguaranteed sukuk, and considers the position of the managing agent

in relation to the extent to which nonperformance of its functions would affect the sukuk's credit quality.

- The stand-alone rating could then be notched up, depending on the nature of the guarantee and the implied enhancement to the sukuk's overall creditworthiness. We assess the capacity of the guarantor to provide timely support to the SPE in case of need, as well as enforceability of the guarantee. We might also place some emphasis on recovery analysis, whenever feasible. This form of analysis can help determine the probability of payment of sukuk holders if adverse events negatively affect the underlying assets or the obligor and/or managing agent, causing default or inability to service required cash flow transfers. In many of the jurisdictions where sukuk are issued, recovery analytics remain difficult to implement.

Example of a partially credit-enhanced sukuk: sukuk al istisna (project) involving an industrial issuer

The transaction involves an SPE issuing sukuk based on the securitization of existing and future project receivables originated by the obligor (see chart 2). The proceeds from the sukuk are often used in this type of structure for funding specific items of plants and equipment or designated capital costs. Revenues collected from the project are the basis for the periodic distributions on the sukuk. On the dissolution of the trust and sale of the project, proceeds fund the dissolution distribution amount payable to the certificate holders, and are equal to the principal of the sukuk. The guarantor funds any shortfall, allowing the SPE to meet its obligations under the sukuk. The guarantee is provided in this case for 50% of the dissolution amount, and constitutes an enhancement factor for the ratings, and an additional comfort factor for sukuk holders.



The rating on istisna sukuk is based on the ability of the underlying assets to generate sufficient cash flow to meet debt service, expected value of the project at sukuk maturity, and also the credit enhancement provided by the partial external guarantee. The guarantor is committed to pay back up to 50% of the sukuk principal amount if the proceeds of the project sale fall short of the sukuk principal amount. Depending on the breadth of this partial credit-enhancement mechanism, we would assess how many notches to apply above the stand-alone rating on the sukuk. In this example, the guarantor does not guarantee the coupon payments.

Our Experience In Rating Sukuk In The Infrastructure Finance/Corporate World

Standard & Poor's has rated three sukuk in this particular field:

- The sukuk of National Central Cooling Co. PJSC (Tabreed; BBB-/Stable/--), issued by Tabreed 06 Financing Corp. Tabreed is an industrial company based in the United Arab Emirates (U.A.E.);
- The sukuk of DP World Ltd. (A+/Stable/A-1), issued by DP World Sukuk Ltd. DP World is also an industrial U.A.E.-based company; and
- The sukuk of Saad Trading Contracting and Financial Services Co. (STSFC; BBB+/Negative/A-2), issued by Golden Belt 1 B.S.C. STSFC is a Bahrain-based conglomerate.

The three sukuk have been structured differently, but have much in common with sukuk that have full credit-enhancement mechanisms. There are, nevertheless, some interesting differences in the way we analytically became comfortable with the ratings assigned to each of the individual sukuk.

Tabreed 06 Financing Corp. (BBB-)

The \$200 million seven-year istisna and ijara sukuk is intended to fund the construction of district cooling plants in the U.A.E. by Tabreed. The sukuk issued by a 100%-owned SPE of Tabreed--Tabreed 06 Financing Corp--benefited from a purchase undertaking provided to the issuer by the parent. The purchase undertaking provides comfort that, in the event of insolvency of the issuer or payment shortfall, the parent has an irrevocable obligation to promptly pay all amounts due under the sukuk. We viewed this payment undertaking as equivalent to a guarantee, meaning that the sukuk could rank *pari passu* with Tabreed's senior unsecured corporate obligations. Had Tabreed's ratio of secured debt to assets been more than 20%, any unsecured debt would have been rated one notch below the counterparty credit rating (but when the sukuk was rated Tabreed's ratio was less than 20%.) Other features include the following:

- The trustee holds issuance proceeds in a transaction account in favor of the sukuk holders. The trustee also holds legal ownership over the assets in favor of the sukuk holders;
- A negative pledge over the assets is held by the trustee in favor of the sukuk holders; and
- The structure includes a cross-default clause and a cash waterfall structure linked to distributions, similar to those on Tabreed's other senior secured debt.

DP World Sukuk Ltd. (A+)

For DP World's 10-year \$1.5 billion sukuk, the parent, DP World Ltd. provided a purchase undertaking to the 100%-owned SPE (borrower). The purchase undertaking's wording was similar to that of Tabreed's. This usually would have led us to equate the rating on the sukuk with that on DP World's corporate obligations, on the assumption that the sukuk had debt-like features equivalent to those of unsecured debt. But because the instrument was structured

as a trust-like sukuk--with periodic payments to sukuk holders funded from mudaraba (joint investment) assets, we instead viewed this sukuk as unguaranteed or otherwise unsupported issuance (excluding any potential role that government would play as 100% indirect owner of the parent.) Standard & Poor's concluded that the sukuk carried some equity-like, loss-absorbing features that would have rendered the debt issue potentially less equal on a ranking status compared with other unsecured debt at DP World Ltd. Ultimately, we did not need to question the ranking status of the sukuk relative to other financings. The reason was our **counterparty** credit rating of DP World Ltd. was based on strong implicit government support for the entity, and we considered that the purchase undertaking provided to DP World Sukuk from its parent also benefited from strong implicit government support. The rating also reflected the strength of the purchase undertaking, which implied that in the event of insufficient payments from the mudaraba assets to meet distributions the shortfall payments by DP World Ltd. would rank pari passu with payments to DP World Ltd.'s other unsecured creditors. All these factors led us to equalize the rating on the sukuk with the **counterparty** credit rating on DP World Ltd.

Golden Belt 1 B.S.C. (BBB+)

Golden Belt 1 B.S.C.'s \$500 million five-year sukuk benefited from an unconditional and irrevocable undertaking by its 100% owner, STCFSC, to make rental payments on the leased assets plus the termination payment (principal) upon maturity of the sukuk. Due to the irrevocable nature of payments under the sublease agreement (just like that of the purchase undertakings in the DP World and Tabreed 06 sukuk), we viewed the Golden Belt sukuk as ranking pari passu with all other unsecured and unsubordinated obligations of STCFSC. Given that STCFSC had no secured borrowings on its balance sheet, there was no issue of structural subordination and the rating was equalized with our long-term issuer credit rating on STCFSC.

Standard & Poor's expects to continue to rate this type of sukuk at the same level as the rating on the parent's senior unsecured obligations. Generally, if the investment-grade parent has a ratio of secured borrowings and other priority liabilities (for example, trade creditors to strong subsidiaries) to assets of more than 20%, then we would likely notch down the rating on the sukuk and on the parent's senior unsecured debt relative to our long-term issuer credit rating on the parent guarantor. On the other hand, if we have sufficient comfort in the security and/or the parent balance sheet consists largely of unsecured borrowings, then we would likely equalize the rating on the sukuk with the rating on the parent. In addition, if the parent guarantor has a strong implicit government-derived rating, then we could factor in government involvement into our assessment of the sukuk financing at the SPE.

Legal Considerations

Standard & Poor's also takes into account the relevant legal and jurisdictional aspects of the transaction in rating a sukuk--no matter what kind. To understand the impact of the underlying legal framework on the ability and willingness of the issuer to make payments on the rated instruments, we may request legal opinions of counsel to analyze the relevant legal issues, such as enforceability, recognition of choice of law, and, particularly in the context of nonguaranteed sukuk, insolvency and security-related matters. Some jurisdictions have features that could prevent us from granting high ratings on sukuk. For example, a number of jurisdictions in the Middle East raise questions about which parties' obligations would be enforceable in local courts, whether they would recognize contractual governing law (for example, in Saudi Arabia), and whether security would be enforceable. Sometimes uncertainties pertaining to the legal environment surrounding sukuk issuances are simply due to the fact that the relevant legal framework has so far been untested, because the laws have been so new and defaults lacking.

New Issue: Sun Finance Ltd.

RATINGS DETAIL

Class	Initial rating	Amount (Mil. AED)	Interest	Step-up margin	Expected maturity	Legal final maturity
A	A	2,761	One-month EIBOR plus 200 bps	N/A	Jan. 2012	Jan. 1, 2015
B	BBB+	251	One-month EIBOR plus 250 bps	N/A	Jan. 2012	Jan. 1, 2015
C	BBB-	1,004	One-month EIBOR plus 350 bps	N/A	Jan. 2012	Jan. 1, 2015

TRANSACTION PARTICIPANTS

Issuer/trustee	Sun Finance Ltd.
PropCo	Sorouh Abu Dhabi Real Estate LLC
Trustee account bank	HSBC Bank PLC, Jersey Bank
Trustee cash manager	HSBC Bank PLC
PropCo account bank	HSBC Bank Middle East Ltd.
PropCo cash manager	HSBC Bank PLC
Trustee auditor	Deloitte & Touche LLP
PropCo auditor	Deloitte & Touche LLP
Valuer	Colliers International, UAE
Collateral	Freehold title to plots of land and rights to payment under sale and purchase agreement
Sellers	Sorouh Real Estate PJSC
Lead managers	Abu Dhabi Commercial Bank, Citigroup Global Markets Ltd., First Gulf Bank, National Bank of Abu Dhabi, and Noor Islamic Bank PJSC
Account bank provider	HSBC Bank Middle East Ltd.
Cash manager	HSBC Bank PLC
Program hedging counterparty	Citibank N.A., London branch
Paying agent	HSBC Bank PLC, Jersey branch
Purchaser	Sorouh Abu Dhabi Real Estate LLC
Security trustee	HSBC Corporate Trustee (UK) Ltd.
Servicer	Sorouh Real Estate PJSC
Back-up servicer	Abu Dhabi Commercial Properties LLC
Originator counsel	Freshfields Bruckhaus Deringer LLP
Transaction counsel	Clifford Chance LLP

SUPPORTING RATINGS

HSBC Bank PLC as account bank	AA/Stable/A-1+
The London branch of Citibank N.A. New York, NY	AA/Negative/A-1+

TRANSACTION KEY FEATURES

Transaction type	The debt is issued in the form of sukuk al-mudaraba al-muqayyada (sukuk) certificates by Sun Finance Ltd. and the proceeds of the issuance are used to invest in accordance with an investment plan under the Restricted Mudaraba Agreement
Closing date	Sept. 11, 2008
Security	First-fixed charge over Sorouh Abu Dhabi Real Estate LLC's offshore accounts, an assignment of its rights under transaction documents, and a floating charge over all of its businesses and assets.
Country of origination	United Arab Emirates
Infrastructure reserve	AED1,735 million
Liquidity reserve account	Six months' sukuk profit payments (AED101.153 million at closing)
Senior expenses reserve account	AED6.85 million
Provision for further issuance	No further issuance

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Publication date:

12-Sep-2008

Transaction Summary

Standard & Poor's Ratings Services has assigned initial credit ratings to the UAE dirham (AED) 4,016 million sukuk al-mudaraba al-muqayyada certificates issued by Sun Finance Ltd.

Since we assigned preliminary ratings to this transaction (July 14, 2008), the arranger has not made any material changes to the transaction.

Sun Finance is a Jersey-incorporated company with limited liability. The transaction involves a plot sales receivables financing company under which Sun Finance receives its cash flows from a property company, Sorouh Abu Dhabi Real Estate LLC (SADRE), domiciled in Abu Dhabi. SADRE delivers infrastructure for Shams Abu Dhabi, a 170-hectare development on Al Reem Island, and the Saraya development in Abu Dhabi's central business district. The project develops only the infrastructure connecting to the individual plots, and not the buildings being built on them.

The repayment of the sukuk certificates is subject to some construction risk, as sites must be fully connected to utility services and other defined infrastructure before the transfer of title to individual developers. The receivables are liabilities of the various building developers, which buy land from the property company, SADRE, on which they will construct their buildings.

The developers make payments in installments for the land during the term of the sukuk certificates, with the freehold ultimately transferred on payment of the final installment. The developers can construct their projects on the plots of land during the period of payment, known as a "musataha," and can take deposits from potential leaseholders in the developments, in many cases before and during construction.

Each developer steps into a sale and purchase agreement with SADRE, which defines the terms of the musataha, including the payments to be made, and when the freehold will be transferred to the developer. It also defines what happens if a developer defaults. The quality of the payment flow and the recovery for the transaction hinge on the incentive for the developer to continue payment installments for the freehold.

The handover of the freehold can be undertaken only once all conditions have been met, including the completion of infrastructure works and connections. The transaction includes an infrastructure fund of approximately AED1,735 million to construct the infrastructure and utility connections, which is funded from the initial issuance. The anticipated completion date for the infrastructure is June 30, 2010, although this can be extended for up to six months without penalty, which is supportive to the transaction.

Shams Abu Dhabi, although a large development in its own right, is a relatively small part of the overall development of Abu Dhabi envisaged in the "Plan Abu Dhabi 2030." This plan sets out the development of the islands and other undeveloped areas in the Emirate to improve the quality of properties, increase the number of dwellings and commercial properties, and significantly increase the tourist attractions and hotel capacity. Properties in Abu Dhabi are of a relatively low standard compared with neighboring Dubai, and many Abu Dhabi workers commute from Dubai because of this.

The transaction is a sukuk certificate issuance, which is underpinned by a structure based on Islamic Law. The sukuk issuance funds the purchase of assets from Sorouh Real Estate PJSC ("mudaraba" assets), which are owned by SADRE, the "mudareb," and which are also used to finance the infrastructure fund for construction, the transaction's liquidity fund, and a senior expenses fund.

The Mudaraba is constructively dissolved monthly, enabling the ongoing declaration of profits and the return of capital to Sun Finance, known as the "rabb-ul-maal." Sun Finance also has an additional "masawama" agreement, which provides an acceptable structure for the prioritization of the notes under Shariah law, resulting in different classes of sukuk certificates to be issued. However, for the purposes of this transaction, the certificates are

issued under English law, under which the seniority of the notes is well established.

Our ratings address the timely payment of profit and the ultimate recovery of capital. We do not rate according to compliance with Shariah law.

Strengths, Concerns, And Mitigating Factors

Strengths

- Freehold price risk is fully mitigated by the plot sale agreements with each development, and the sale of freeholds is pre-agreed.
- Sizing of the debt against the expected payment provides a good degree of certainty regarding ultimate repayment.
- Plot sale agreements in favor of SADRE provide a strong commercial incentive for developers to meet the term payments.
- There is a reasonably diversified range of developers.
- There is a clear timetable of payments during the life of the transaction.
- The notes have a medium-term nature (maximum four years for most junior tranches).
- The infrastructure construction costs are pre-funded from the debt issue.
- Free cash after declared profits is fully swept into the repayment of the notes.
- The levels of interest coverage during the construction phase are relatively high.
- There is strong government interest in the development of the two projects as part of the Abu Dhabi 2030 plan to provide high quality residential, commercial, and tourist facilities in the Emirate.
- A liquidity reserve facility covers any shortfall in rabb-ul-maal profit during the life of the transaction, sized at three months' interest payments.

Concerns

- The property law in the Emirate of Abu Dhabi is recently established and untested.
- The estimated individual credit quality of the developers is weak.
- There is a weak security package, with issuer's rights to direct the PropCo based largely on rights established under the mudaraba trust.
- There is limited construction risk relating to completion of infrastructure to support the plot sale agreements.
- There is limited independence of the SPE due to its ownership by two non-executive officers of Sorouh Real Estate PJSC ("Sorouh").
- Sorouh has a strong influence on the operational aspects of the transaction.
- No support is factored in from the sovereign.
- The contract is based in UAE law, which has limited track record for transactions of this nature.
- In a default, ultimate recovery will be based on the reliance on UAE courts.

Transaction Structure

The structure of the transaction is shown in chart 1.

Chart 1: SUN FINANCE LTD. TRANSACTION STRUCTURE

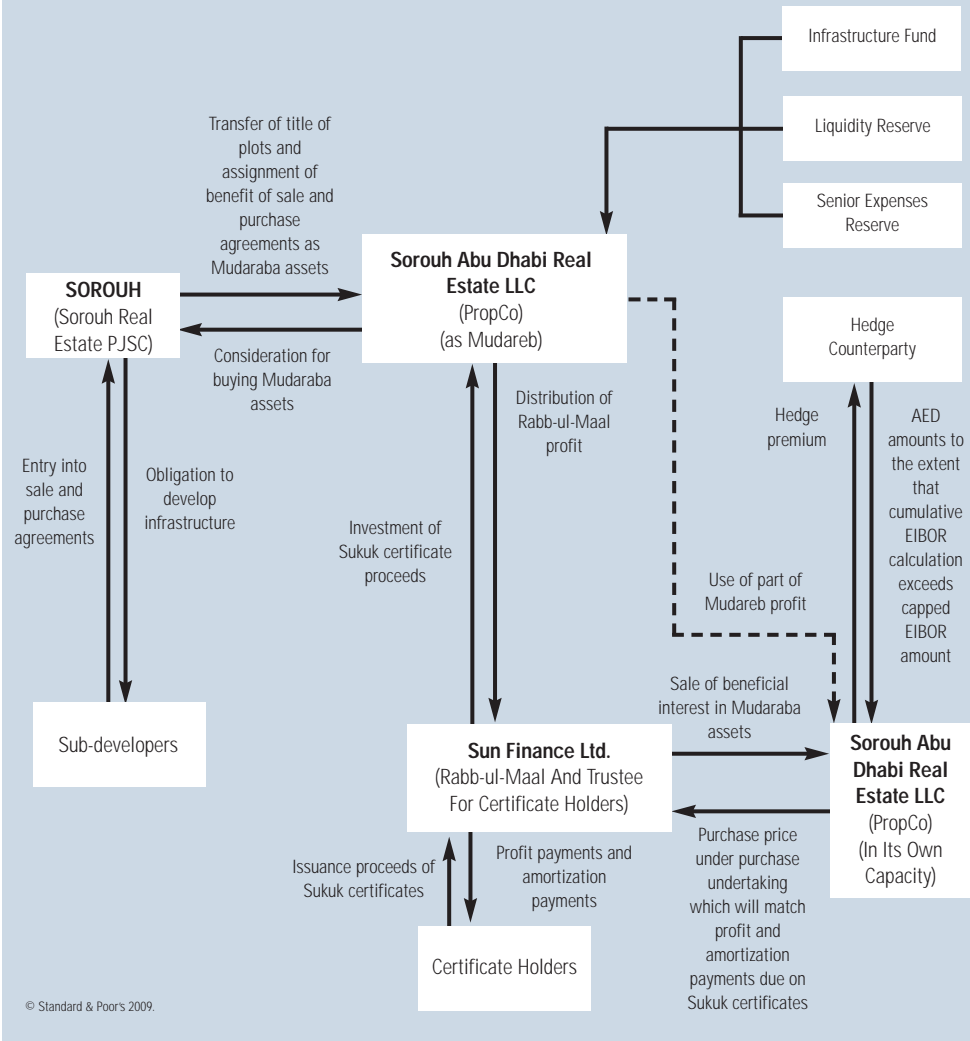
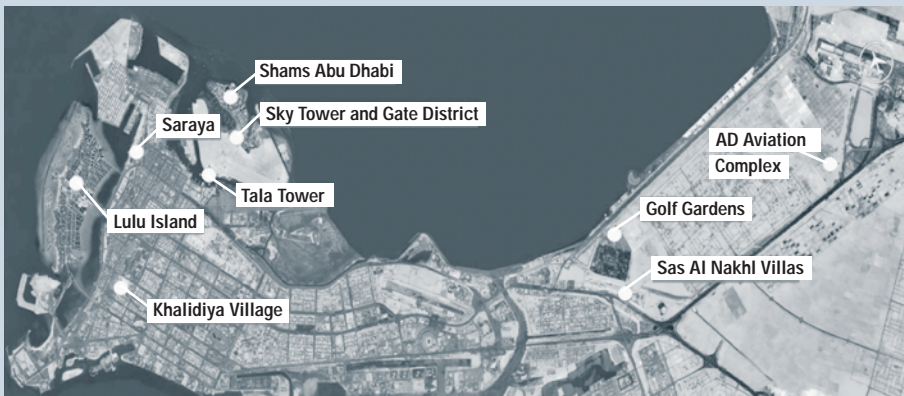


Chart 2: AERIAL VIEW OF SOROUH'S PROJECTS



Business Description

Description of the project

Sun Finance is a property receivables financing transaction with some elements of construction risk. The receivables are undertakings by building developers, which are acquiring land from Sorouh Real Estate PJSC (Sorouh), on which they will construct their buildings. The developers make payments in installments for the land, and freehold is transferred to the developers upon payment of the final installment. However, the developers construct their buildings on the plots of land during the period of payment under a Musataha agreement. The developers can take deposits from potential leaseholders ahead and during construction. As the developers progress further with the plot development, there is a greater incentive to complete development as each developer over time increases its equity position in the plot.

The original owner of Shams, Abu Dhabi Land LLC, sold the land to Sorouh under a musataha agreement in October 2005. This contained an option for Sorouh to acquire the freehold of the land, which was exercised in April 2007. Similarly, the individual developers can develop the plots under a musataha agreement (as long as they are Gulf Cooperation Council (GCC) nationals, non-GCC developers enter into usufruct agreements), with the freehold ultimately being transferred to the developer once the final installment has been paid for the land.

Each developer enters a sale and purchase agreement (SPA) with the property company, SADRE, which defines the terms of the musataha, including the payments to be made, and when the freehold is transferred to the developer. It also defines what happens if there is a default by a developer.

The handover of the freehold can be undertaken only once all conditions have been met, which includes the completion of infrastructure works and connections, which is subcontracted out to construction companies. The transaction includes an infrastructure fund of AED1,735 million to construct the infrastructure and utility connections, which is funded from the initial issuance of the sukuk certificate. The anticipated completion date for the infrastructure is June 30, 2010, although this can be extended by Sorouh for up to six months.

Sale And Purchase Agreement

The SPA contains the following features which support the credit quality of the transaction:

- The purchase price for each plot is paid in pre-agreed installments.
- The purchase price can be adjusted by SADRE if the size of the plot varies by more than 5% from the original plan.
- SPAs originally agreed by Sorouh are transferred to SADRE without the need for third-party approvals.
- Construction by the developers must be in line with plans already approved by Sorouh and identified in the Abu Dhabi Plan 2030. Sorouh, as the project manager, has the right to force a developer to stop work if the design does not match the pre-approved plans. This can also be done for infringements onto other plots, or poor working practices.
- A developer can be required to set up an escrow account if it intends to enter into sales contracts with third parties; the escrow can be for up to 20% of the construction cost. Sorouh may use this escrow if there is a default by the developer.
- If the developer defaults, Sorouh can terminate the SPA, re-sell the plot and any buildings, claim compensation for any direct loss, retain amounts already paid to cover losses, retain the building without compensation, and liquidate the escrow account. The potential loss of

the value of the plot by the developer, including the value of construction already undertaken on the plot, provides a significant incentive to continue payments under the plot sale agreement. The sizing of plot sale agreement payments is somewhat smaller than the costs of plot development.

Business risk assessment

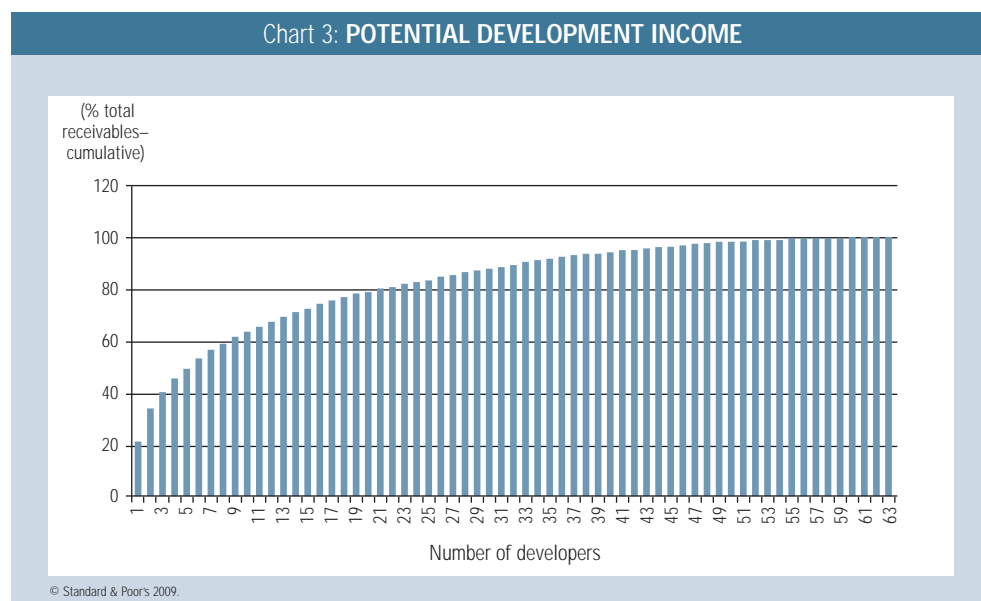
The quality of cash flows relies on the collection of payments under the plot sales agreements. This is reliant on:

- Sorouh's performance as the collection agent, or its replacement in a Sorouh default or insolvency.
- The efficiency of the check-based payment system in Abu Dhabi.
- The operation of Abu Dhabi's recently established property law.
- The solvency of the developers on each of the plots.
- Sorouh's ability to meet construction targets for the development of the infrastructure.
- The ongoing demand for the new properties in Abu Dhabi.

Developer Credit Risk And Financial Model

The cash flow that is being securitized is generated by periodic payments made from 62 developers, based on 109 plots in both the Shams and Saraya developments. Cash flows generated from these periodic payments over the next 4.5 years (from September 2008 until January 2013) are designed to pay transaction senior expenses, and profit and principal on the rated certificates. Assuming there are no disruptions to the developers' cash flow payments, these total outstanding payments to SADRE will amount to about AED5,715 million over the term. On a net present value (NPV) basis and assuming a discount rate of 7.5% (which represents the coupon on the certificates and senior expenses), this equates to AED5,396 million.

There is a significant concentration of developer cash flow, with the dominant developer representing 21.5% of the potential cash flow and the top five developers representing 47.5%. Chart 3 shows the developer concentration risk, where the number of developers is graphed against potential cash flows they generate. Certain developers may have better credit quality than assumed, although specific financial information on these developers is not available. For instance, Global Investments, which accounts for 5% of the cash flows, is a significant investment fund. Furthermore, 10% of the cash flows come from Quad Land, a joint venture of Tameer, which is a larger property company than Sorouh. In addition, 21.5% of cash flows come from Gate Land, which is the largest development on the Shams—a fully fledged Tameer development. Finally, 7% of the cash flows are related to developments by royalty.



As a mitigant to the concentration of potential developer cash flows, the bulk of the income is generated over the first three years and represents 81% of potential income (as demonstrated in table 1). In the first year, almost one-third of cash flows will be generated for the benefit of the transaction. If any sub-developer cash flows are removed from the transaction, it is assumed that the full payment under the relevant plot sale agreement will be made at the time, with a matching prepayment of outstanding debt.

DEVELOPER CASH FLOW PAYMENT PROFILE						
	July 2008 to June 2009	July 2009 to June 2010	July 2010 to June 2011	July 2011 to June 2012	July 2012 to January 2013	Total
Mil. AED	1,894 (33%)	1,475 (26%)	1,276 (22%)	841 (15%)	229 (4%)	5,715, (100%)
Mil. \$	515 (33%)	401(26%)	347 (22%)	229 (15%)	62 (4%)	1,556 (100%)

Limited information has been provided on the individual developers. In our analysis, we have assumed that the developer companies would have a vulnerable credit risk profile. Given the lack of detailed information about the financial strength of most of the developers, we have assumed necessarily conservative corporate default rates for a corporate entity.

Stress Case Scenario

Given the risk profile of the developers over the 4.6-year term of the scheduled cash flows, we have assumed that approximately 55% of the cash flows of the developers would default. As a result of the potentially high degree of industry correlation between the developers, we have concentrated these defaults in various windows of time. In our analysis, when a developer defaults, we have assumed that any future cash flows generated from that particular project may not be recoverable. In reality, a new developer could take over the defaulted developer's project and generate future income, which may ultimately improve the recovery.

By concentrating defaults at the beginning of the transaction, we can assume a more stressed scenario. For example, in certain scenarios we assumed that over half of the cash flows would default within the first six to 12 months of the transaction. This means that all cash flows are received up to month six and the remaining potential cash flow will be received from six to 12 months from the closing of the transaction until the end of the transaction. Other scenarios have assumed equally high levels of default on the remaining potential cash flow concentrated in specific time intervals over the term of the transaction.

From our analysis, it appears that the cash flows are robust even in stressed scenarios with high levels of default and no recoveries. This is driven by strong potential cash flows at the beginning of the transaction, where about 81% of potential cash flows are generated within three years of closing, and 59% are generated within two years of closing. Additional stresses may consider higher levels of default, and much earlier in the transaction.

Construction And Contractual Risk

Unusually for a property receivables financing transaction, certificate holders are modestly exposed to construction risks relating to the delivery of basic infrastructure services to each of the 109 plots making up the Shams and Saraya developments. Infrastructure requirements include dredging, marine walls, roads, bridges, sewerage, water, electricity, gas, and district cooling.

The contracts entered into by Sorouh for the infrastructure are somewhat weaker than would be expected for project finance, e.g., they do expose the project to limited cost and delivery risks. Furthermore, compared with other single-asset project financings, the level of construction risk cover, through letters of credit or performance bonds, is somewhat low. However, this is offset by the linear construction program (there is a low degree of interdependency of various aspects of the construction), and the relatively benign ground conditions. In addition, there are no additional permissions that need to be obtained to allow construction. The bulk of construction has started, and the certain heavy construction elements, such as sea walls, earthworks, deep sewers, and dredging, are either close to or have achieved completion.

In addition, the handover of plots occurs on a staggered basis, which limits the delivery risk. SADRE is also not subject to a penalty on late completion of the freehold sale, although it may delay cash flows.

The project has entered into a number of contracts relating to the infrastructure works. These are:

- Lump sum contracts (fixed price turnkey contracts): If the scope changes, the profit margin on the contract remains fixed. This includes penalties for late delivery, which passes some of this risk on to the subcontractors.
- Re-measured contracts, where the scope of the work cannot be precisely identified, particularly dredging and reclamation, earthworks, and utilities. This relates to the bulk of the contracts, which creates an element of cost risk for the project. However, much of the major work is underway.
- Non-tendered contracts: These have not yet been tendered, which could create a cost risk if tender amounts come back higher than expected.
- The bulk of contracts being used are re-measured contracts.

Most infrastructure delivery up to the boundary of the Shams project is undertaken by Bunya LLC, which gets funding from the government for regional infrastructure development. Bunya's delivery times depend on the major utilities, but all of these companies are state-owned and run, and the incentives for delivery in time are aligned. Shams is not the only development on Al-Reem Island, and infrastructure delivery is expected to be coordinated.

There are limited performance bonds assigned to Sorouh's benefit, and these relate to the contracts for marina and sea wall construction, and the construction of bridges and canals, which form the larger part of the construction. Sorouh has drawn up a contingency of smaller modular delivery of energy, water, and sewerage, which supports the handover of the infrastructure while the anticipated infrastructure design is delivered.

Sorouh is responsible for ensuring that infrastructure works are adequately completed

under the PSA contracts with the developers as a condition of payment by the developers. Sorouh has entered into a series of subcontracts for the completion of the infrastructure. The most significant subcontractor is the project management consultant on the infrastructure works (Hill); Hill is expected to be retained as the consultant if Sorouh defaults.

Responsibility to monitor sub-developers

Aside from Sorouh's infrastructure work obligation, the other key construction risk component of the project is the PSA between Sorouh and the developers. This agreement stipulates that the developers must complete the construction of buildings within a certain timeframe (master community open date).

Before a developer can start works on a plot, the design must be agreed/approved by the Abu Dhabi Municipality and Urban Planning Council. The plot specification covers growth floor area (GFA), height, parking, and type of use. Sorouh monitors the construction and ensures that the design complies with the master plan; developers may be forced to stop construction if they are not complying with existing permissions.

Construction has already started on a number of sites and Sorouh will carefully monitor the progress. If at any stage the developer fails to meet minimum standards required by the Abu Dhabi Municipality (as laid down in the master agreement between the municipality and Sorouh), then Sorouh can terminate the contract with the developer and re-sell the plot to another developer. Sorouh can do this without achieving consent of the Sukuk certificates in this transaction. This therefore introduces an additional element of counterparty risk uncertainty.

Sorouh must ensure that the construction of buildings at the various plot sites is conducted in a coordinated manner and that supplies can reach all plots at all times to ensure successful completion. Sorouh must ensure that some element of phasing out and sequential construction is administered over the various plots to prevent clogging of roads and supply routes. These aspects are overseen by Sorouh's main project management consultant.

Major Stakeholders

The sponsor, Sorouh Real Estate PJSC, is an investor-owned, Abu Dhabi-based property developer. The ownership of Sorouh is varied, with members of the royal family, banks, investment companies, and independent investors as shareholders. Importantly, and unlike Aldar Properties PJSC (A-/Stable/A-2), there is no state ownership in Sorouh, and we treat it as a standalone entity from the state. The top 20 shareholders account for just over 47% of ownership, with members of the royal family accounting for about 25% of the total ownership; the largest shareholder, Al Joud, is a Shariah-compliant fund for GCC investment launched recently by Abu Dhabi Investment House, a large investment fund itself established in 2005.

Shareholders Agreement/Meeting SPE Criteria

The PropCo, SADRE, is jointly 99%-owned by the chairman and managing director of Sorouh Real Estate PJSC. The remaining 1% is held by an independent director. If Sorouh defaulted, 100% ownership would revert to the independent director to prevent Sorouh or its administrators affecting the structure. This limits the effect of a Sorouh default on the certificate holders, and should ensure the continued operation of collections. The minority shareholder is, on the other hand, independent of Sorouh and represents the interests of the security trustee, which in turn acts on the issuer's behalf. The minority shareholder has certain rights over decisions pertaining to security held at the PropCo (discussed later), which are intended to provide the issuer with some control over management of the PropCo's security.

The owners of SADRE, in their function as directors of Sorouh, are heavily incentivized to ensure that the project performs, however, to ultimately benefit Sorouh and its shareholders, thus maximizing the cash flow and recovery available for the lenders to Sun Finance. In addition, the project and its involvement in the Abu Dhabi Plan 2030 carry a high degree of reputational risk for Sorouh.

Sorouh also acts as the managing agent, providing billing and collection services, although the cash flow does not commingle with Sorouh's own, but is paid directly to SADRE. The 100% cash sweep into profits and capital redemption while the certificates are outstanding, means that the sponsor cannot access cash until the certificates have been fully repaid.

Some element of ring-fencing has been established at SADRE/Sun Finance, which is adequate for the purposes of separating the transaction's credit quality from Sorouh's standalone credit quality, which is viewed as weak.

SADRE's activities are limited, with restrictions on incurring debt, entering into acquisitions, mergers, and disposals (the latter being only allowed subject to Sorouh's insolvency). SADRE's business purpose is essentially to act as an intermediary between Sorouh and the issuer in terms of transferring funds from plot sale to the issuer, to enable the issuer to meet debt service under the notes. SADRE also holds title to plots for a limited period until the developers have paid all installments on the plots, at which point ownership transfers to the developers. SADRE's roles and responsibilities are defined under the Mudaraba Agreement and the Property Management and Services Agreement.

Issuer SPE incorporated under English Law

Sun Finance is incorporated in Jersey and is a shell (orphan) entity with no links to Sorouh or any other corporate. The issuer also has limited business purpose, which is to raise a finite amount of debt under the transaction. The issuer's roles and responsibility are defined by its obligations under the following agreements: (i) Restricted Mudaraba, and (ii) Trustee Cash management agreement, and C) Declaration of Trust.

The Declaration of Trust entered into by Sun Finance is governed by English law, accordingly security or subordination of the notes is also established under English law.

Transfer risk

Developer payment for plot sales is made in dirhams in favor of the PropCo's accounts established in Jersey. The sukuk certificates are issued in UAE dirhams, mitigating any convertibility risk.

SADRE has entered into a cap arrangement with Citibank N.A. (AA/Negative/A-1+) based on an EIBOR strike price of 5%, which limits the structure's exposure to interest rate movements during the life of the transaction. This is based on the amortization profile of the transaction assuming a 'BBB' stress scenario. If the cumulative EIBOR element of the profit payment from SADRE to Sun Finance exceeds AED330 million, then the counterparty pays SADRE the difference between the cap and actual EIBOR.

Sorouh as servicer (Sorouh credit risk)

Sorouh acts as the servicer of the project while it is operating, and is responsible for the billing and collection of cash on behalf of the project. It also acts as the manager of the development of both Shams and Saraya. There is a large degree of Sorouh operational risk throughout this project.

The risk of commingling with Sorouh's credit risk is low, as all developers pay for installments by check, which, in Abu Dhabi, is seen to be the least contestable form of payment, and preferred by the banks. Indeed, if a check is bounced by a payer, it is a criminal

offence in Abu Dhabi. Although Sorouh is responsible for billing and managing the payments during the life of the transaction, checks are paid directly to SADRE, and cash is directly cleared into a UAE dirham account in the name of SADRE.

In a default of Sorouh, however, a replacement property manager already identified as Abu Dhabi Commercial Properties LLC, a wholly owned subsidiary of Abu Dhabi Commercial Bank (A/Stable/A-1), is appointed, and it enters into the Property Management and Services Agreement, under which it manages payments and plot sale agreements and appoints project management consultants to ensure that the infrastructure is built.

Legal framework

Security. The security trust deed creates security in favor of the secured creditors, which comprises:

- A first-fixed charge over the PropCo offshore accounts and the eligible investments in connection with the PropCo offshore accounts;
- An assignment of the PropCo's rights under the PropCo transaction documents; and
- A floating charge granted by the PropCo over all of its business and assets (excluding the plots and the PropCo's other rights under the Mudaraba assets sale agreement).

Certificate holders benefit from a relatively weak security package, which allows them to enter into fixed and floating charges over the assets and the bank accounts of the issuer SPE, Sun, as well as the assets of SADRE. However, we have doubts over the certificates' ability to effectively enforce security under the restricted Mudaraba agreement and the plot sales agreements, given the lack of track record in the enforcement of plot sales agreements under the new property laws. This effectively limits the most senior tranche's ability to attract a higher rating. However, the involvement of the government of Abu Dhabi in establishing the property laws, and the importance of the Plan Abu Dhabi 2030 to the region, lend some weight to the fact that the laws should operate as intended.

Although the issuer can in fact instruct the minority shareholder in SADRE to force a sale of assets held by the PropCo in a Sorouh insolvency event, there is limited certainty as to the interpretation of certain actions by the courts in Abu Dhabi. We expect that the recovery of capital on the sukuk certificates in an issuer default will be achieved through the ongoing collection of cash from the developers, rather than any attempt to crystallize the value of the structure at that point through a sale or refinancing.

Shariah Compliance And Subordination

The operation of the subordination, through the operation of a musawama, is outlined below.

- We do not rate to the sukuk structure or Shariah compliance, but rate the underlying credit quality of the certificates.
- The sukuk certificates are issued under English law out of the Jersey SPE, and the tranching does not take into account the operation of Shariah law.
- The musawama structure is not specifically included in the documentation for the transaction.
- The mudaraba is dissolved monthly, although estimated profits rather than actual profits are declared.
- Lenders to the structure implicitly agree that the musawama structure complies with Shariah law.
- The subordination is achieved based on the timing of payment to each of the tranches: tranche B cannot start being repaid until tranche A is repaid, and likewise for tranche C until tranche B is fully repaid.

Cash flow waterfall

At each calculation date, cash is paid in the following order:

- Cost and expenses of under the declaration of trust;
- Cost and expenses relating to the sukuk calculation period;
- 2.5% of profit payments to the class A, B, and C certificates;
- Remaining profit payments to the class A certificates;
- Remaining profit payments to the class B certificates;
- Remaining profit payments to the class C certificates;
- Amortization payments to the class A certificates unless repaid in full;
- Amortization payments to the class B certificates unless repaid in full; and
- Amortization payments to the class C certificates.

Covenants

The transaction has limited financial covenants relating to the nonpayment of periodic distribution amounts in full, with no remedy within 10 days. The structure is specifically restricted from taking on additional debt, having employees and subsidiaries, or becoming involved in any other business. Events that are specifically excluded from creating events of default include noncompliance with Shariah law at any time.

Purchase undertaking insulates transaction from Sorouh corporate risk

It is notable that the purchase undertaking in this transaction does not equate at all to a corporate guarantee from the sponsors (parent). Although a lot of the mudaraba mechanics associated with this transaction are similar to what we saw with DP World, the key difference here is that the purchase undertaking is not a purchase undertaking from Sorouh (the parent) to redeem the full value of the notes (principal and interest) in an issuer default—which would have made this transaction a pure Sorouh corporate risk transaction. Rather, the purchase undertaking provided by the PropCo is only as strong as the quality and level of cash flow received by the PropCo from the developers.

If developers do not pay adequate cash flow to the PropCo, then upon exercise of the purchase undertaking, it may not be possible for the issuer to receive the full amount of interest and principal to service all the debt. The ability for the issuer to service all debt outstanding (including principal), in other words, depends entirely on the quality of cash received by the PropCo.

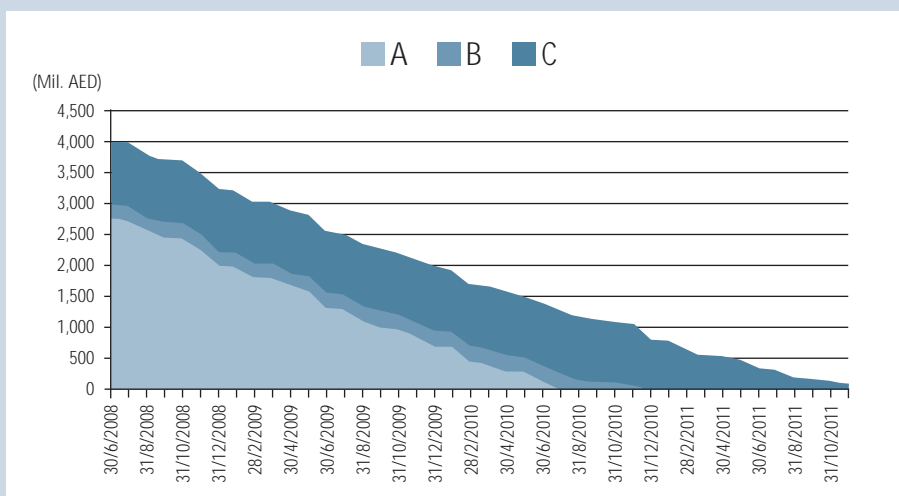
Maturity

All debt is anticipated to be repaid by July 2011, with the senior tranche repaid by June 2010, giving it a term of under three years.

Repayment

Chart 4 shows the repayment distribution among the different classes of sukuk certificates.

Chart 4: REPAYMENT DISTRIBUTION



The repayment of profit and capital is sculpted according to the forecast payments by the developers under the sale and purchase agreements already scheduled. Capital repayment reflects total cash flow available after profit payment. The two more junior tranches do not start to be repaid until the next, more senior, tranche is fully repaid. Any cost overruns that occur on the project will only become evident once the infrastructure fund is exhausted, which could affect repayment of the senior tranche at the back end of transaction.

No dividends are paid to the owners until all principal is fully repaid.

Currency swap agreement

The notes are issued in UAE dirhams, the same currency as the cash flows.

Security for the notes

The security for the certificates is limited.

Standard & Poor's Approach To Rating Takaful And Retakaful (Islamic Re/Insurance) Companies

Introduction

The past five years have seen takaful (Islamic insurance) grow from a niche product servicing relatively limited demand--both by geography and client--to become a mainstream risk management offering. Particularly well established in the Far East, especially Malaysia and Indonesia, it is now growing rapidly in the Arab world, and expanding across Europe. With the development of takaful, the growth of retakaful was seen as inevitable as a necessary and Sharia compliant version of reinsurance.

Standard & Poor's Ratings Services has rated a number of Islamic insurers and reinsurers. In this article, we comment on the way that our rating criteria have been adapted to address the particularities of this product.

We note that our ratings on takaful and retakaful companies do not address Sharia compliance. A Standard & Poor's insurer financial strength rating is a current opinion of the financial security characteristics of an insurance organization with respect to its ability to pay under its insurance policies and contracts in accordance with their terms. We treat the mechanisms employed to deliver Islamic insurance solutions in a Sharia-compliant model as being a management decision over the operation of the company business model. The religious context itself is not part of the credit rating decision.

The analytical categories

Standard & Poor's insurer financial strength ratings generally focus on the following categories of analysis:

- Industry and economic risk
- Management and strategy
- Competitive position
- Enterprise risk management
- Earnings
- Investments
- Liquidity
- Capitalization
- Financial flexibility

Generally, no single category dominates the assignment of or action on a rating. Relevant rating factors may include how well, in our view, the capital base is managed and how robust it is to absorb likely earnings volatility, and how the earnings stream is suited, in our opinion, to support liquid assets to enable prompt claims settlement.

Standard & Poor's generally publishes a detailed commentary in support of each rating, covering each of the analytical categories highlighted above. Below, we identify those aspects of the (re)takaful business model that may be subject to specific consideration, or special treatment in Standard & Poor's analysis.

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Publication date:

30-March-2009

Industry And Economic Risk

We consider the effectiveness of the regulatory regime that the (re)takaful company is working within. Insurance supervisory bodies set minimum operational standards at some level to minimize the risk of insurance company failure, but typically regulation in any domicile only draws a line, below which companies may not operate. How far above those minimum standards a company chooses to operate is entirely a decision for owners/management. We observe that no special regulatory treatment is currently given to the (re)takaful sector relative to the conventional equivalents. International insurance supervisors, we understand, are generally consistent in their view that the (re)takaful business model is, for their purposes, a "normal" insurance model and should be regulated consistent with other insurance models in terms of solvency/capital adequacy requirement and regulatory filings.

We assess economic risk by reference to Standard & Poor's sovereign ratings, and may adapt our assessment to reflect the likely potential demand for Islamic insurance in the operational domicile. For instance, we believe that countries with a large Islamic community are likely to have stronger economic/business drivers than where the Islamic population is smaller. We also consider this factor under the Competitive Position section.

Competitive Position

Under this category, Standard & Poor's seeks to assess the ability of the current and targeted business source to provide a lasting, profitable revenue stream to the insurer. We believe at this stage that takaful is still a developing business that has to prove itself against conventional insurance structures. However, contribution (premium) growth has typically been very rapid, which raises the question, in our view, whether the management and the systems of (re)takaful companies have the ability to keep up with this growth, and whether they have adequate capital availability to properly support it. Where takaful companies are in direct competition with conventional insurers, as indeed most are, Standard & Poor's generally assesses evidence of product demand and persistence before giving an opinion. The takaful model typically includes a profit-share component to contributors as a necessary component, and to date we view the effectiveness of this client tie-in to future income for relatively new companies as unproven.

As Islamic entities, takaful companies' income streams can be constrained by the application of strict Sharia compliance to the nature of the risks being offered. We understand that in some circumstances, the risks accepted will be broken down into Sharia compliant and noncompliant components, with any profits from the latter being donated to charity, or eliminated in some form.

Management And Strategy

Here we form a view on the skills of the management team in setting an effective operational framework to support the business development. Given the hybrid nature of the (re-)takaful structure, we also seek to understand how the goals of the takaful members, which are generally more focused on risk sharing, align with the goals of the shareholders, whose motives are usually more profit orientated.

Enterprise Risk Management

Enterprise Risk Management (ERM) is an adjunct to Management and Strategy, encompassing an assessment of the risk appetite and control framework of the company. In this regard, Standard & Poor's approach to takaful companies is generally no different than to "conventional" insurance companies.

Earnings

The assessment of the earnings quality for takaful companies can be more complex than for other companies in our view because of the often separate reporting of financial statements for takaful fund members and shareholders. As noted above, the concept behind takaful is mutual risk sharing, or cooperative risk pool participation. The takaful funds, paid for by member contributions bear the losses of the individual member. This, of course, is the original insurance model: the many pay for the losses of the few. At the technical level, therefore, we consider that underwriting earnings may be expected to be more marginal in terms of profit contribution over the long term, as members may expect lower risk pricing on this shared risk basis, or a profit share distribution at some point from any surpluses.

We note that the majority of takaful companies operate the wakala (or agency) model of technical fund management, under which the operational costs are borne by the shareholder, and recovered through a wakala fee levied on the takaful fund. This fee is usually set in advance of the underwriting year, and agreed with the Sharia council, often as a percentage of contributions. In measuring the performance of the takaful underwriting account, Standard & Poor's will generally replace the wakala fee with the actual operational costs borne by the operator. We believe this gives a more comparable assessment of underwriting performance against conventional insurers, through analysis of the classic technical measures of gross and net combined ratios. A further factor we consider is the relationship between the wakala fee and the operational costs; any margin could, we think, represent a meaningful profit for the shareholder, or subsidy to the takaful fund.

One of the paramount features seen in the takaful model is that any deficit on the takaful fund is solely the responsibility of the members to fund. Nevertheless, under this hybrid structure, the shareholders will usually provide a cost-free loan (qaad hassan) to the fund to finance any shortfall, recoverable from future surpluses. This therefore puts the onus on the operator to price takaful risks correctly to enable the fund to meet claims liabilities. As part of our rating analysis we assess how likely underwriting will be profitable over the long term, so as to provide a flow of funds to finance claims liabilities and growth.

The takaful funds also earn income from the invested assets. However, these invested assets are usually again managed by the operator, who takes a profit share from this activity--the mudharib share.

Typically, the shareholder income statement reflects investment income earned on shareholder assets, the mudharib share and wakala fee from the takaful fund, less any operational costs. In its narrow sense, these items provide return to shareholders. However, Standard & Poor's also includes the surplus (deficit) from the takaful fund, as calculated above, to measure a "conventional equivalent" return on equity.

Investments And Liquidity

Standard & Poor's analysis in these two categories is generally no different for takaful companies than for conventional insurance companies. We form a view on the credit and market risk qualities of the chosen investment portfolio, and the quality of its structure and management. The portfolio structures are likely to be very different for the takaful fund assets and the shareholder funds assets and we assess the strengths and weaknesses of both.

Capitalization

Capital adequacy

Standard & Poor's generally uses its risk-based capital adequacy model to assess the capital quality of the company. The key adaptation is to offset any takaful fund deficit against the shareholders' capital in our analysis, as we understand that the shareholders are obliged to offer support for any such shortfall. Similarly, we will generally include any takaful fund surplus as part of the capital base.

Reinsurance

There are no notable adaptations for this component of our analysis, but we observe that Sharia boards are increasingly expecting takaful companies to seek Islamic reinsurance (retakaful) and availability may become an issue.

Reserving

Again, there are no notable adaptations for this component. Insurance is protection against the unknown, and we therefore look to determine to what extent there exist, in our view, conservative loss assessment processes that bear comparison with peers, and are vetted by independent actuaries, both general and family takaful funds.

Financial Flexibility

Standard & Poor's will also assess to what extent a company's management is able to demonstrate its ability to raise money to support the entity. Shareholder funds are, in our view, the backbone of the business, and we generally assume them to be fully defrayable against any fund deficit, based on the respective qaad hassan loan facility. Typically under this facility, if a deficit on a takaful fund cannot be replenished, then the assets of the shareholders will be called upon to make good any shortfalls.

Takaful Spreads Its Wings As An Alternative Insurance Business Model

Islamic scholars consider the classic risk-transfer model through insurance to be unacceptable for use in Islamic communities. This religious doctrine may be compounded with cultural issues, contributing to the poor level of development of insurance markets often seen in Islamic regions.

The world's Islamic population is estimated to comprise some 25% of the global total: a meaningful "risk-transfer" market by any standard. Therefore, in recent years, the Islamic, Sharia-compliant "takaful" model for insurance has come to be considered a key factor in increasing insurance awareness and delivering a successful, expanding business platform. This can be seen most clearly in the Gulf Cooperation Council (GCC) region, which is also capitalizing on rapid positive economic development.

For example, in the United Arab Emirates (UAE), overall market gross premiums grew by over 30% in 2007. Contributions (premiums) within the takaful sector increased by roughly twice this rate, so these companies are growing very rapidly within a dramatically expanding economy. Similar takaful contribution growth rates are evident in other regions. However, takaful activity is low in absolute terms, contributing less than 10% of the total regional market share.

Expansion Could Extend Beyond The Uninsured Market

The opportunities for increased uptake of takaful insurance in the GCC should be positive. The considerable economic growth in the region, coupled with a sizable, underinsured population, means that there are substantial prospects for further development of personal lines cover. The ability of the industry to persuade potential policyholders of the need for and benefits of insurance, as well as to successfully meet customer demands, remains unproven, however. Takaful operators sometimes present an unclear business model: "takaful" is a religious concept, so should the service be available to, or attractive to, non-adherents to Islam? The business prospects for takaful are not wholly derived from the personal lines sector, although this was originally thought to be its obvious focus. Prospects have also emerged in the commercial sector, where takaful operates in direct competition with the traditional insurance market.

One of the problems facing takaful is the lack of awareness among retail customers of the social and individual benefits of insurance. That said, the future success and sustainability of this pace of development will depend on a number of factors that, within personal lines, are just as relevant to the traditional as to the takaful regional markets.

The takaful market faces some unusual challenges. It has to match the service quality of the traditional insurance market and persuade an uninsured market to use its facilities. Takaful companies must demonstrate a credible alternative to the traditional market, over and above the initial religious affiliation.

Increasingly, however, traditional insurers are creating new takaful divisions or subsidiaries into which they can accept risks. This operational model achieves the key requirements:

- It meets Sharia council approval;
- It is accepted by the Islamic community and policyholders;
- It passes regulatory requirements; and
- It delivers real economies of scale.

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Publication date:

14-Jul-2008

Long-Term Success Needs Greater Focus On Profitability

Stand-alone takaful companies are likely to face more difficulties achieving economies of scale, compared with their rivals among the takaful subsidiaries that are backed by traditional insurers. Future takaful development will be constrained unless operators can create demand and increase awareness of the need for insurance. The onus remains on them to emphasize the broad appeal of Islamic insurance. The growth of Islamic finance, and in particular retail Islamic banking solutions such as Islamic mortgages and credit cards, is certainly encouraging and will help the insurance sector.

In terms of underwriting performance, to date, takaful has not necessarily been the more profitable approach. Standard & Poor's would expect application of the general concept of mutualization of risks to moderate profitability and, as expected, average combined ratios for takaful companies have been higher than for traditional regional peers. Although the essence of takaful is cooperative risk sharing and community well-being, rather than profit maximization, continued underwriting profitability will be important to support future growth and retain the support of shareholders. This is particularly true in view of the shareholder's compulsory takaful fund support mechanism via the "qaad hassan" facility.

Retakaful Support Is Emerging

A growing number of Islamic reinsurance (retakaful) companies are being established and the success of this sector has to be directly linked to the success of the primary "takaful" sector. All the points made above relate also to retakaful players. Looking further ahead, investors could be considering the creation of a "retotakaful" marketplace to support the young retakaful market, and this holds up the opportunity for a parallel Islamic risk-transfer market alternative to the long-standing "traditional" model.

In summary, Standard & Poor's expects the global takaful sector to continue its rapid growth and that it will become a significant contributor to the global "risk-transfer" marketplace. That said, the competitive environment will remain challenging, because members of the traditional insurance market should have the ability and tools to match the ambitions of the Islamic sector members. At present, the building blocks to service this growing facility are still being put in place in the form of new primary takaful and retakaful capacity. Most takaful companies are still local organizations, but we see great opportunities for real regional leaders to develop and service the growing insurance needs of the Islamic community, and also to attract non-adherents.

Islamic Finance In France: Paris Tries To Reduce The Gap With London

Islamic finance has grown exponentially over the past decade, and London has positioned itself as a major Islamic banking center, while France has adopted a slow, or at least conservative, approach. France is now maneuvering for a part of the business, though, with expected fiscal and legal adjustments as announced in July 2008 by the finance minister.

Islamic finance has been one of the most dynamic asset classes over the past decade with total assets exceeding \$700 billion. Standard & Poor's Ratings Services believes that the industry will continue growing at double-digit rates in the foreseeable future. Over the past five years, London has built up its Islamic finance capabilities through regulatory and fiscal adjustments, the licensing of five Islamic banks (four wholesale banks and one retail bank) and a takaful company, and the authorization for conventional players (estimated at about 20) to offer Sharia compliant products in the U.K.

The French have lagged the British over that period, but recently the French government signaled a change in attitude. It is set to adjust its fiscal and legal framework to render it friendlier to the development of Islamic finance. The recent communication from the French ministry of finance asking the relevant government administrations for the fiscal and juridical clarifications and modifications necessary to facilitate sukuk issuance and structured real estate transactions--in particular regarding registration rights--came as no surprise and was welcomed by market participants. By preparing the ground for Islamic finance, France can help financial innovation and benefit from the deep pockets of Middle Eastern investors as liquidity has dried up elsewhere in the global financial markets.

Standard & Poor's believes that there is good potential for Islamic finance in France, although its development will be gradual in our opinion. At first, we expect mainly wholesale banking and sukuk to fuel growth. Some uncertainties persist regarding the development of Sharia compliant retail banking services, despite the fact that France has the largest Muslim population in Europe.

(For definitions of terms, please see our "Glossary Of Islamic Finance Terms," published Jan. 7, 2008, on RatingsDirect.)

Wholesale Banking Services And Sukuk Will Be The Main Growth Engines

Standard & Poor's believes that wholesale banking and the sukuk market will be the main drivers of growth in French Islamic finance, at least in the first stage of development. The fiscal and legal adjustments are set to render the French environment friendlier to the development of Sharia compliant financing programs, funds, and sukuk. These adjustments will help financial innovation in France and improve corporations' and investors' access to alternative financing and investment products. They will also help reduce the gap with the U.K., which aims to establish itself as the major Islamic financial platform in Europe.

The timing of these adjustments is good. Global market dislocation and investors' wait-and-see attitude have tightened liquidity and widened spreads in the international capital markets, while high oil prices have resulted in additional liquidity in the Gulf with relatively limited investment opportunities. Like those of its mature financial market peers, the French economy is highly diversified and offers several asset classes eligible for Sharia compliant transactions.

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Publication date:

21-Jul-2008

Introducing Islamic finance would benefit both French corporations and leading Islamic investment banks. French corporations would be able to tap the growing sukuk market and attract a portion of the huge liquidity pool available in the Middle East and Asia. At the same time, leading Islamic investment banks would be able to further access a mature and stable country such as France and diversify their risks through private equity transactions and funds.

We think the real estate sector has especially strong potential. Clearing the way for cash rich investors should help support the French real estate sector, given the high appetite of Middle Eastern investors for this asset class.

Offering Islamic Finance Products Could Activate Latent Retail Banking Demand

At about 5 million, the Muslim community living in France is the largest in Europe. Given the size of this target market, Standard & Poor's believes that a latent demand for Islamic finance exists in France but has never been tapped as no Islamic finance offer is available. The size of this demand is, however, difficult to assess.

The profile of the Muslim population in France is quite different from that in the U.K. Some U.K. citizens do not actively deal with banks simply because banking in the U.K. is based on interest, called "riba" in Arabic and considered unlawful according to Sharia. To prevent Muslim customers from being excluded from the banking market because of their beliefs, the British Financial Services Authority has given conventional banks the green light to offer Sharia compliant services and has even licensed a retail bank (Islamic Bank of Britain). In France, the banking penetration ratio is one of the highest in Europe and French Muslims seem to be well integrated within the system. It remains to be seen if authorizing Islamic retail banking in France would prompt French Muslims to switch from conventional banks to Islamic offerings.

Muslims are not the only retail customers that could be interested in Sharia compliant products. Some non-Muslim customers interested by "ethical" investments could be sensitive to the prohibition of the financing of some economic sectors deemed as unlawful by Sharia and the profit and risk sharing principles embedded in Islamic finance.

Islamic Finance Could Benefit French Banks

Authorizing Sharia compliant products in France would provide opportunities for French banks. Some (such as BNP Paribas, Société Générale, and Calyon) already offer Sharia compliant products in Middle Eastern countries and could replicate this offering in their local markets. However, very few, if any, have yet performed a detailed viability or profitability study of this market and the business model to be put in place. It remains to be seen if Islamic finance will emerge in France, and if so, at what pace and under what form.

When Finance Converges With Faith

Islamic law, or Sharia in Arabic, is a comprehensive body of principles and precepts developed over the past 1,400 years. Until just a few years ago, Sharia compliant financial services almost exclusively targeted retail households in principally Islamic Middle Eastern states and Malaysia. Islamic investors had also historically retained a performance bias toward shorter maturities. Under these circumstances, asset and liability management practices remained fairly rudimentary. But now, with the growing influence of petrodollars and the increasingly sophisticated investor population, there has been a surge in the development of Islamic finance and banking products. Today, Muslims are investing closer to home and are demanding Sharia compliant alternatives. This practice has resulted in more globally diversified risk-adjusted portfolios, entry into alternative asset classes, and dynamic multi-asset class strategies. Standard & Poor's estimates that as of year-end 2007, Islamic financial products, including banking, real estate funds, equity funds, fixed income, insurance, project finance, and private equity, represented a US\$700 billion market, which is growing at 10% per annum.

As wealth among predominantly Muslim societies continues to grow, it has begun transitioning to second generations. Combined with wealth created by the new entrepreneurial class, Muslim investors are open to sophisticated investment concepts while maintaining wealth management principles that align with Sharia. Compared with conventional investment holdings, Sharia has gained increasing influence for Muslims. Two primary factors have made this possible: Sharia scholars are continuously refining Islamic jurisprudence and authorizing the implementation of innovative investment techniques, and Islamic banks, supported by global investment banks now entering this space, are refining their products and services to cater to a broad array of Muslim requirements. These banks are motivated to capture the capital flows between states in the Gulf and the rest of the world, notably Southeast Asia.

Sharia scholarly research is the driving force behind innovation in the financial engineering of Sharia compliant instruments. It was previously presumed that there were impenetrable constraints on the potential of Islamic instruments. The swaps or options in conventional finance do not exactly equate to Islamic finance's waad (promise) or murabaha contracts. Yet no matter how the instruments' mechanics differ, their objectives are to provide comparable investment benefits. The advancement of Sharia compliant portfolio management would have been stifled without scholarly insight.

The growth of Muslims' assets is causing a migration from concentrated domestic and regional portfolios to internationally diversified holdings through structured asset management. Any such development of the capital markets requires structural resources. In the case of Sharia investing, an increase in available products and services over the last two years has ignited latent demand that had previously been insufficiently addressed.

Sharia indices are beginning to establish structural resources. These indices are now used to prescribe the mechanisms of strategic asset allocation (optimal returns), tactical asset allocation (medium-term forecasting) and dynamic allocation (short-term adjustments or momentum-related strategies). They have created a unified framework from which to assess diversified investment opportunities, evaluate performance among asset managers, and monitor the operational risks associated with various investment classes. A Sharia index

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**This article was produced
by S&P Index Services**

Publication date:
7-Jul-2008

ultimately represents the value at which investor money exchanges hands, whether that be through fund subscription/redemption or through a structured product payout.

In proposing Sharia services, an institution must first choose an appropriate methodology that will appeal to a broad distribution base. Standard & Poor's Sharia indices are used by fund houses and institutional investors in a top-down approach. The choice of an acceptable methodology confers legitimacy on the ensuing program of services. Sharia indices provide general religious compliance screening for stock selection, operational daily control across custodial holdings, and validation of benchmark selection options for active managers who trade in small caps and the emerging markets space.

Sharia indices also create investment vehicles for the general public. Legal setup costs for individual products can be high, and Sharia products must be approved by the issuer's dedicated Sharia board. If issuers can standardize product ranges as they do in conventional banking, high legal setup costs can be amortized across a broader distribution base and fees can be compressed for the end investor.

HSBC and Citigroup have recently been joined by the likes of Deutsche Bank, BNP Paribas, Barclays, ING Investment Management, and Prudential AM in offering Islamic finance options for investors. Malaysia's Labuan International Offshore Financial Center (IOFC) is a prime illustration of where and how the global industry is expanding in the Islamic space. As of 2007, 58 international banks, 21 trust companies, and 131 insurance companies had incorporated activities in the IOFC to capture the Sharia trade and investment flows through this financial hub.

Where A Growing Offer Is Answering To Latent Demand

During the early part of this decade, Sharia products and services largely consisted of OTC (over-the-counter) issuance and private banking networks. These include sector-driven cash basket trading, narrow fund allocations, and discretionary mandate management for high net worth individuals. Certificates have proven the most popular form of structured products recently with declining interest rates and increased volatility in global equity markets. Many certificates rely on Sharia constant proportion portfolio insurance (CPPI) mechanisms to achieve 100% capital protection.

Sharia equity indices represent the bulk of new Islamic vehicles coming to market. Because a Sharia equity index is as liquid and cost-effective as its underlying conventional index, time-to-market for new equity products can be rapid. In the Middle East where best practices are increasingly being applied in asset management, risk-controlled benchmarking is becoming the norm. Fund companies such as Jadwa Investment apply Standard & Poor's Gulf Cooperation Council (GCC) Sharia benchmarks as the performance measure to their regional equity portfolios. As Middle East investors seek to globalize allocations, large players like NCB Capital are extending their Sharia fund range into more sophisticated equity classes. For instance, the Alahli Global Real Estate Fund is now offered thanks to the S&P/Citigroup Global Property Sharia Index, the first global listed real estate Sharia index published daily. The first Malaysian global property fund was submitted for regulatory filing in 2008 after this index's launch.

The growing Sharia demand pull, however, is not reserved to markets in these predominantly Muslim states. Demand from large Muslim constituencies in Europe and Southeast Asia has risen with the growing availability of new public vehicles. In all states, the successful development of Islamic finance is contingent on players proposing a wide range of financial products that satisfy and realistically serve the needs of asset allocation and diversification of return opportunities.

This year saw the launch of two broad landmark Sharia ranges tailored for global diversification opportunity. Deutsche Bank structured three new Sharia-compliant exchange-traded funds (ETFs) to be listed on five European exchanges under its db x-trackers brand: S&P 500 Sharia, S&P Europe 350 Sharia, and S&P Japan 500 Sharia. These three vehicles alone, which are Undertakings for Collective Investments in Transferable Securities (UCITS), Sharia compliant, and available to investors in all European markets, could be articulated as the core of any balanced equity portfolio. For the first time, Muslim investors can compose a balanced exposure, make regional plays, or trade entire markets at once with all the inherent benefits of ETFs, a convenience previously reserved for conventional investors.

SGAM Alternative Investments (SGAM AI) also registered its first Luxembourg-based Sharia umbrella fund this year. The structure includes five compartments: the S&P 500 Sharia, S&P Europe 350 Sharia, S&P Japan 500 Sharia, S&P BRIC Sharia, and S&P GCC Sharia. Although the new funds are subscribed directly through SGAM and not traded on an exchange, this umbrella structure adds emerging market options into the asset allocation mix.

The European Union's largest Muslim constituency resides in the U.K. where we find mandatory defined contribution pension schemes. Here, issuers such as SGAM AI have the ability to propose a complete range of Sharia compliant retirement savings solutions to U.K. corporate and local council platforms. For the first time, the average British Muslim has access to a globally balanced choice with which to manage and protect future wealth generation.

As institutions increase their efforts to provide Sharia-compliant products, innovation becomes the differentiating factor. The market standard for any institution successfully active in Islamic finance is a holistic approach that integrates the choices and benefits of modern financial theory for a broad audience of investors.

Creating Sharia-Compliant Equity Indices

In December 2006, Standard & Poor's responded to the needs of Muslim investors by launching three Sharia-compliant indices using three headline indices as parent indices. We screened the S&P 500, the S&P Europe 350, and the S&P Japan 500 for Sharia compliance. The resulting compliant stocks were put together in the S&P 500 Sharia, S&P Europe 350 Sharia, and the S&P Japan 500 Sharia. These indices offer an Islamic version of the parent index that closely tracks its performance and provides investors with credible tools for measuring the markets.

Standard & Poor's based its Sharia index development on a three-pronged approach. We applied the premise that Islamic investors' index needs would be similar to those of conventional investors. Hence, we segregated all future index offerings into three distinct categories:

1. **Standard & Poor's Benchmark Sharia Indices:** These are broad-based indices that are comprehensive, transparent, and capture as much of a country's or region's market capitalization institutionally available and investible. The S&P/Citigroup Global Broad Market Index (BMI) includes about 12,000 securities from 52 countries and captures over 98% of the market capitalization of each country included. Its strengths include a 17-year-old set of rules that is consistent across regions and uses transparent methodology. We created the index by using the conventional BMI as the parent index and screened it for Sharia compliance. Currently, with a compliant pool of almost 6,000 companies from 52 countries, we have the broadest offering among all competing index providers in number of securities covered. The S&P World Sharia provides the Sharia-compliant version of the developed world. The S&P Emerging Markets Sharia is a benchmark for emerging markets

and includes 1,650 compliant companies as of February 2008. We have country indices for all 52 countries in the Global BMI and sector indices based on the Global Industry Classification System available on demand.

2. Standard & Poor's Investible Indices: We replicated several indices under the Sharia model based on the format made famous by the S&P 500. In this approach, we chose a specific number of securities based on their size and level of liquidity. These included the S&P 500, S&P Europe 350, S&P Japan 500, and a few other indices in Asia and emerging markets. We then screened all these indices for Sharia compliance to make them available in Islamic versions of the indices.

3. Standard & Poor's Sector and Strategy Indices: Standard & Poor's has also been the leader in creating indices that address particular themes in specialized sectors. The S&P Property and REIT indices have recently gained enormous popularity for their innovative methods of index computing, with special weighting and capping methodologies. Among Islamic investors, the S&P/Citigroup Property and REIT Sharia have become rather popular with Islamic investors. We have created other Sharia indices for investors interested in BRIC markets and infrastructure.

Construction Of Sharia-Compliant Indices

Standard & Poor's derived its new Sharia equity indices from two major fatwas (legal opinions handed down by Islamic religious leaders), one issued in the late 1990s and the other in 2003. As with all other Islamic financial products, a Sharia supervisory board of Islamic scholars oversees construction and maintenance of compliant indices, including their structure, documentation, and related information services. Neither the requirements of the indices nor those of individual investors are among the board's primary concerns. They are more concerned in monitoring adherence to Sharia principles, interpreting relevant business issues, and recommending actions related to index management. The board provides the fundamental principles that determine the index constituents' eligibility, how the ongoing rebalancing is conducted, and how often the index is reviewed. The Standard & Poor's board members are:

Muhammad Ali Elgari

Dr. Elgari is an associate professor of Islamic Economics and Director of the Center for Research in Islamic Economics at King Abdulaziz University in Saudi Arabia. He is an expert at the Islamic Jurisprudence Academy (OIC), Economics. He also serves as an advisor to several Islamic financial institutions worldwide and is the author of many books on Islamic banking.

Abdul Sattar Abu Ghuddah

Dr. Abu Ghuddah is a senior Sharia Advisor to Albaraka Investment Co. of Saudi Arabia and holds a PhD in Islamic Law. Dr. Ghuddah has published many books on Islamic Financial transactions and is an advisor for Islamic Law Encyclopedia (Kuwait Awqaf Ministry). He is a member and chairman of several Islamic Sharia Boards.

Nazih Hammad

Dr. Nazih Hammad is a member of the Fiqh Council of North America and a member of the

Islamic Fiqh Academy. He previously worked as a professor in the Faculty of Sharia at Umm Al-Qura University in Saudi Arabia. He holds a PhD in Islamic Law from the University of Cairo, Egypt.

Mohammad Amin Ali-Qattan

Dr. Qattan is a lecturer and author of several texts and articles on Islamic economics and finance. He is a Sharia advisor and auditor to many banks and finance companies globally. His PhD is in Islamic Banking from the University of Birmingham, U.K.

Index construction, selection of constituents, and any business decisions related to indices are within the purview of the index provider, Standard & Poor’s.

Generally Accepted Principles Of Sharia Compliance

Compliance screenings for companies is done on a sectoral basis and an accounting ratio basis. Sector-based screening filters out stocks in the following business activities that are considered unacceptable under Sharia and that would not be appropriate for investment by observant Muslims: pork, alcohol, gambling, financials, advertising, pornography, investment management, venture capital, and media (newspapers are allowed, and sub-industries are reviewed individually).

During the selection process, Standard & Poor’s reviews each company’s audited annual report to ensure that the company is not involved in any non-Sharia-compliant activities. Those found to be noncompliant are screened out. The following charts (Charts 1 to 3) compare the Global Industry Classification Standard (GICS) sector weight breakdown of the S&P/Citigroup World, S&P/Citigroup Emerging Markets, and S&P 500 Sharia indices with their conventional counterparts. Sharia screening is most evident in the financials sector.

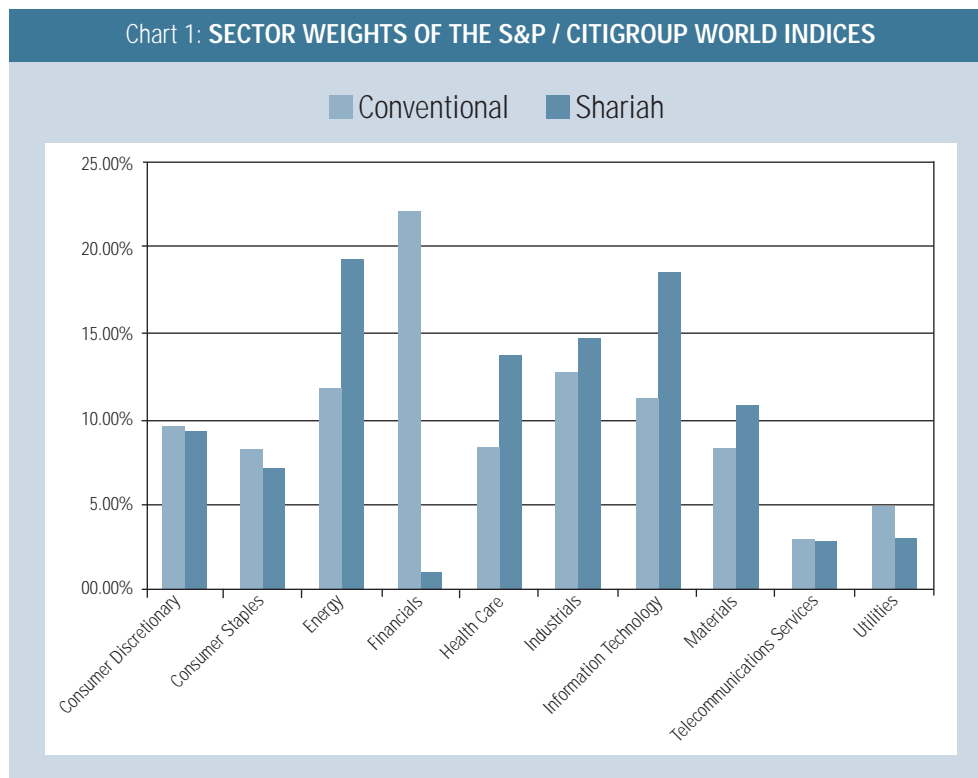


Chart 2: SECTOR WEIGHTS OF THE S&P EMERGING MARKETS INDICES

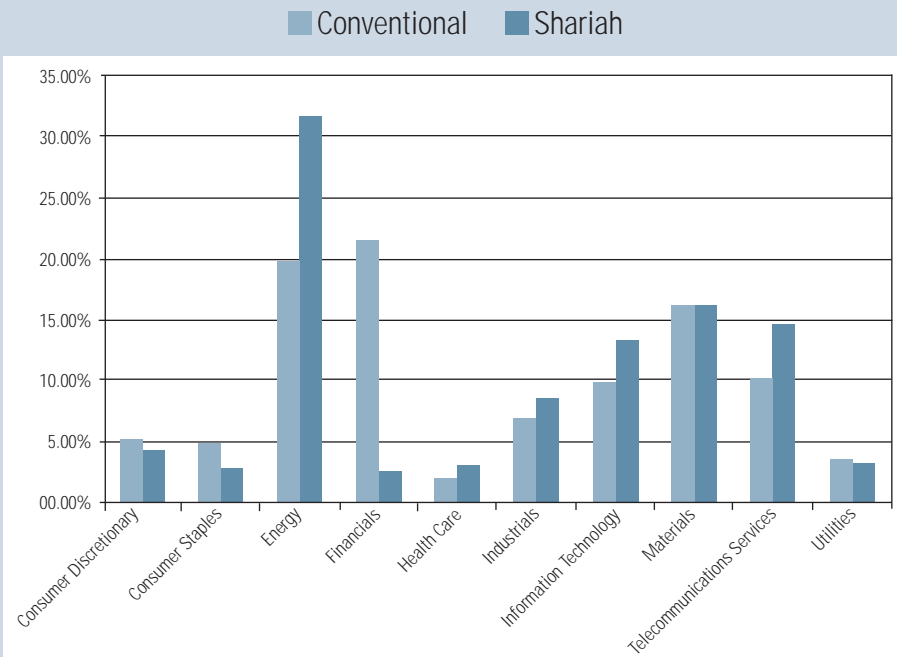
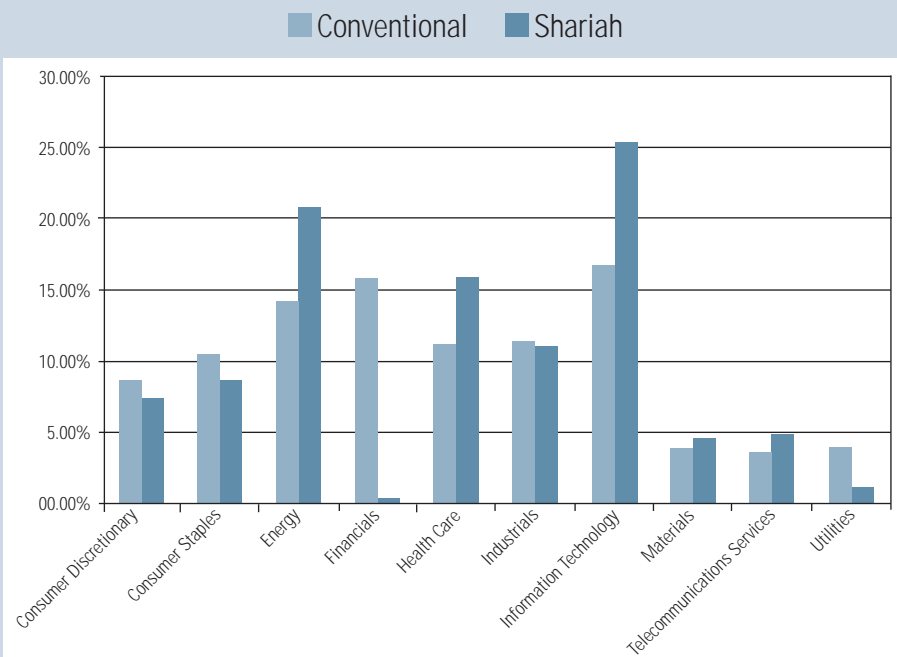


Chart 3: SECTOR WEIGHTS OF THE S&P 500 INDICES



Accounting-Based Screens

After removing companies with noncompliant business activities from the indices, we examine the remaining companies for compliance of financial ratios. We focus on leverage, cash, and the share of revenues derived from noncompliant activities to see whether certain ratios may violate compliance measurements as determined by a Sharia board.

Building A Sharia Compliant Equity Index

By applying Sharia principles to our headline indices, we obtain comparable Sharia investment tools. We maintain stock inclusion for the S&P Sharia indices on a two-tier basis.

Equities are first selected for the underlying conventional index, and only these are eligible for the Sharia compliant version. We then screen the underlying indices' existing constituents using the filters mentioned earlier. Stocks that pass the screen remain in the Sharia index, and those that are deleted from the underlying index are removed from the Sharia index. Similarly, we review stocks that are added to the underlying index for compliance before adding them to the Sharia version. We monitor all stocks in the underlying conventional indices to ensure ongoing compliance and constantly review annual reports to measure any changes in business activity or accounting ratios.

Commercial Applications Of Sharia Equity Indices

Sharia investment offerings are used for mutual funds and have now become popular for creating structured products. Structured products are relatively narrow, liquid baskets and are focused on specific sectors and regions. They are primarily sold as structured deposits or mutual funds. However, they can be relatively more expensive to create, and retail customers have little access to them.

The recent increase in acceptance of Islamic finance has led to a surge in the number of players entering the market. The industry, however, is witnessing a phenomenon somewhat similar to the initial days of the dot-com boom: the existence and exuberance of too many players. Although this period of saturation will likely be followed by a period of consolidation and standardization, Islamic finance and Sharia compliant equity indices are here for the long haul.

Comparison To The Dow Jones Islamic Market Indexes

Dow Jones introduced the Dow Jones Islamic Market (DJIM) Indexes in 1999 as the first benchmarks to represent Sharia-compliant portfolios. Like Standard & Poor's family of Sharia indices, DJIM indexes are maintained following a stringent methodology. An independent Sharia supervisory board counsels Dow Jones Indexes on matters related to the compliance of index-eligible companies. Notably, Muhammad Ali Elgari and Abdul Sattar Abu Ghuddah serve on both the DJIM and Standard & Poor's boards.

Screening For Noncompliant Business Activities

DJIM indexes, like Standard & Poor's indices, exclude from their consideration companies involved in the production or sale and services of pork-related products, alcohol, gambling, financials and media. DJIM indexes also exclude defense and weapons companies, whereas the Standard & Poor's indices consider them on a case-by-case basis.

Accounting-Based Screens

Like Standard & Poor's indices, DJIM indexes subject issuers to a series of financial ratio screens to remove companies based on debt and interest income levels. Both index families have a screen on the total debt, the sum of case and interest bearing securities, and the account receivables. The allowed limits respectively are: <33%, <33% and <49% for Standard & Poor's and <33%, <33% and <33% for DJIM. All values are measured against the 12-month average market capitalization.

- Trading gold and silver as cash on a deferred basis is not allowed in the Standard & Poor's methodology, but is allowed in the DJIM indexes.
- For business classification, the Standard & Poor's indices require noncompliant revenue to be less than 5% whereas the DJIM indexes solely use an Industry Classification Benchmark based filtering system.
- Another subtle issue is the consolidation of balance sheets and income statements for certain markets, most notably, Japan. The Standard & Poor's indices use nonconsolidated data with a view to sum up debt/revenue contribution for each subsidiary depending on the holding in the subsidiary.

Whilst FTSE was the third provider to enter the Sharia index space, FTSE has focused its business activities on Asian markets. A number of differing methodology points of the FTSE Sharia series include:

- A third party Sharia consultant is responsible for determining compliance based on data supplied and filter only by FTSE.
- FTSE Sharia indices are revised on a quarterly basis, as compared to monthly for S&P Sharia indices.
- A 5% flat purification ratio is applied to all dividend payments which may not faithfully reflect the actual level of haram (unlawful) operations of each index constituent.

Conclusion

A spurt in the number of players and products is moving Sharia-based investing to the forefront and beyond the traditionally active Malaysian and Gulf States. The proliferation of new investment vehicles ranges from diversified mutual funds to structured products and to more ETFs trading in the developed markets. This surge is responding to Islamic investors' needs by offering services comparable in diversity and quality to those of conventional finance. Standard & Poor's demonstrates its strong commitment by offering the market a complete suite of benchmark and investable Sharia indices that mirror those which have been longstanding staples in conventional finance.

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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