INDUSTRY AT CROSSROADS

Thomson Reuters Barwa Sukuk Perceptions & Forecast 2016

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Contents

MARKET OPINION

Executive Summary

This is the fourth consecutive Sukuk Perceptions & Forecast Study published by Thomson Reuters. In this 2016 study we continue to provide forward-looking analysis of the global sukuk market, including insights from a wide range of investors and issuers through our Sukuk Survey, as well as market opinion through leadership articles and interviews with key market players.

KEY HEADLINES

Market uncertainty slows down the sukuk market after a strong year

A buoyant 2014 had sukuk market players optimistic for another robust year but market uncertainty, especially with the drop in oil prices and the expected increase in global interest rates, have dampened activity in the market.

Dearth of new issuers contribute to undersupply

The global sukuk market in 2015 welcomed significantly fewer new issuers compared to 2014. In fact there was only one new issuer -- the Omani government, which issued its debut sovereign sukuk in October, 2015 (Oman's first sukuk was a corporate issuance from Al Tilal Development Company in 2013).

Total sukuk issued in the first 9 months of 2015 significantly dropped by 38.6% to $48.8 billion compared to $79.5 billion for the same period in 2014. Sukuk issuances will not break the $100 billion mark, much less surpass the $114.08 billion chalked up in 2013.

There are two fundamental reasons for this plunge in issuance: the decision by Bank Negara Malaysia (BNM) to stop offering short-term sukuk, and the dearth of new players which has limited the market's outreach. While a measurement of the volume of sukuk is needed to assess year-on-year growth, we stress the importance of new issuers to the global sukuk market as a gauge of the widening acceptability of the instrument.

By sectors, Financial Institutions (FIs) lead all corporate issuances for the first 9 months of 2015, followed by Transport, Construction, Real Estate and Conglomerates. The market welcomed 2 new sectors in 2015: Information Technology and Consumer Goods, both represented by Malaysian companies.

Demand strengthens as supply falls

Ample liquidity, limited investment options and a supply shortage are driving demand. The shortage has forced many investors to hold on to their sukuk, resulting in a paucity of trading in the secondary markets.

Despite the drop in issuance, Malaysia remains the most liquid sukuk market, making up approximately 50% of the global sukuk market, thanks to strong primary market issuance and secondary market infrastructure.

The decision by Bank Negara Malaysia (BNM) to stop offering short-term sukuk has created an impediment for many investors, especially those from the Middle East who were comfortable deploying their excess cash in these short-term sukuk.

Based on growth trajectories we have revised our forecast for the sukuk supply and demand gap given global market conditions. We forecast the gap for the next 5 years to be $90.2 billion in 2015, growing to $179.7 billion in 2018, and $$253.7 billion in 2020.

Outlook for 2016

In the era of low oil prices and anticipation of increasing interest rates the outlook for the global sukuk market remains positive. We see the drop in oil prices as a double-edged sword; many oil-exporting countries, such as Bahrain and Saudi Arabia, have started considering sukuk as a source of funding to cover their budget deficits. At the same time, the oil price drop could hurt their credit ratings; this has already happened -- at the end of October Standard & Poor's downgraded Saudi Arabia's sovereign rating, citing a "pronounced negative swing" in the Kingdom's fiscal balance.

The increase in global interest rates is another concern both issuers and investors are closely following as any increase in interest rates will have implications on sukuk. However, the only factor distinguishing sukuk from other instruments is its demand. This could be an advantage for issuers, who will be able to capitalize on limited investment options available to Shariah-sensitive investors and secure better pricing.

A healthy pipeline of US$32 billion is already in place for 2016. This is made up of a mixture of governments and corporates. Some of the potential issuers in the pipeline include countries such as Egypt, Tunisia, Thailand, South Korea and Ivory Coast. There are also quasi-sovereign issuers from Bahrain, Azerbaijan and Malaysia. Corporate issuers make up most of the list with countries from both traditional and non-traditional markets and from different sectors.

Global Sukuk Market up to Q3, 2015

Amount of sukuk Issued

US$48.8 billion

Number of sukuk issued

513

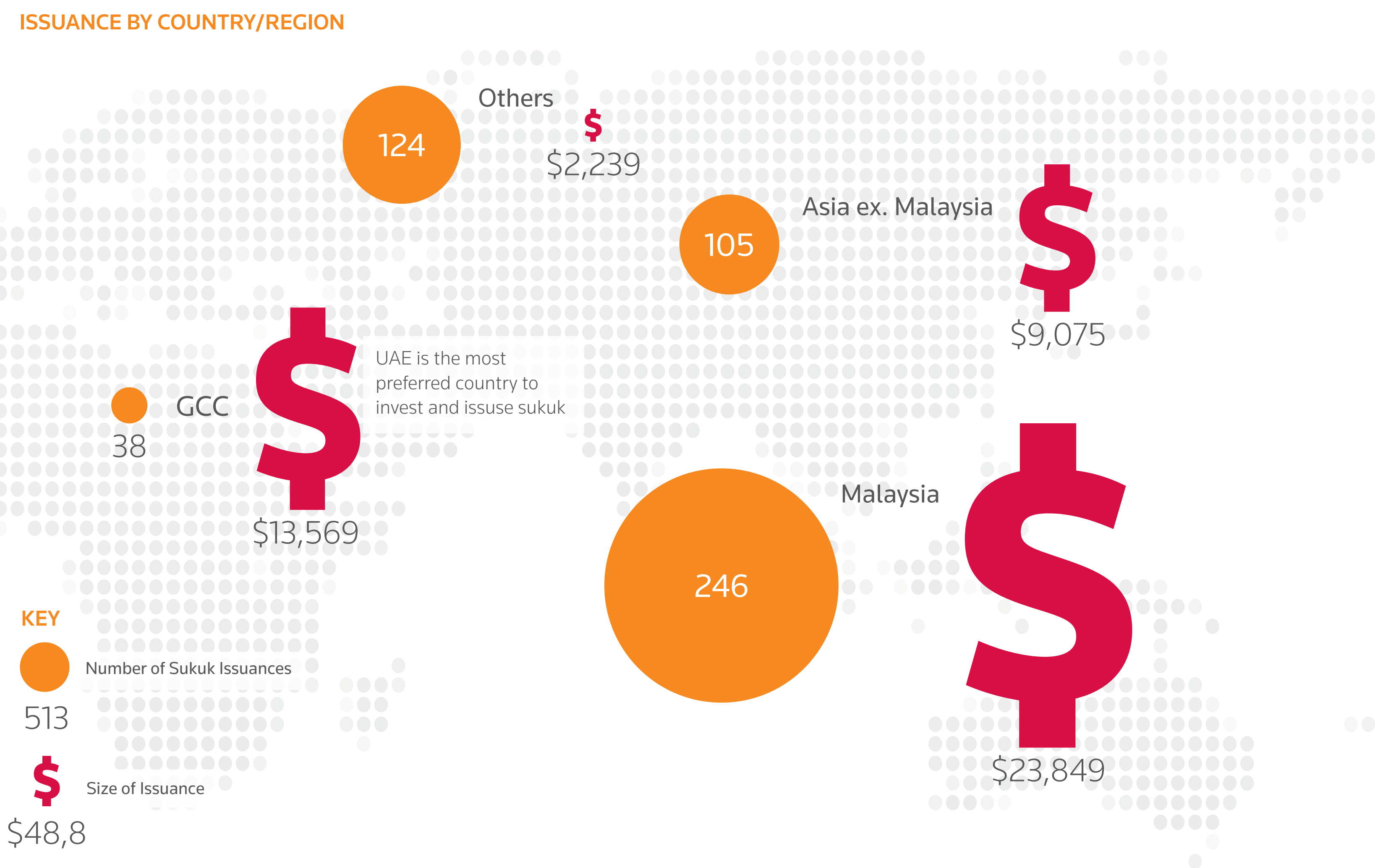
Amount of sukuk outstanding

US$338.3 billion

Projected size in 2020

US$395.5 billion

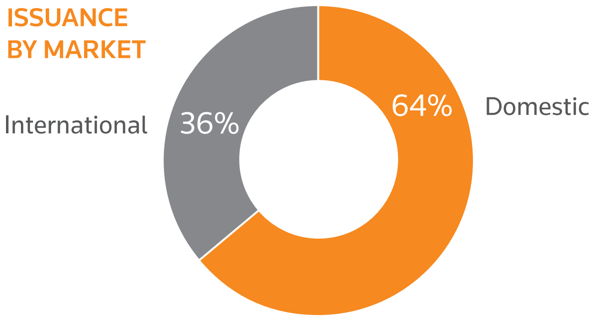
USD is the most issued currency in 2015 and remains the most preferred as well



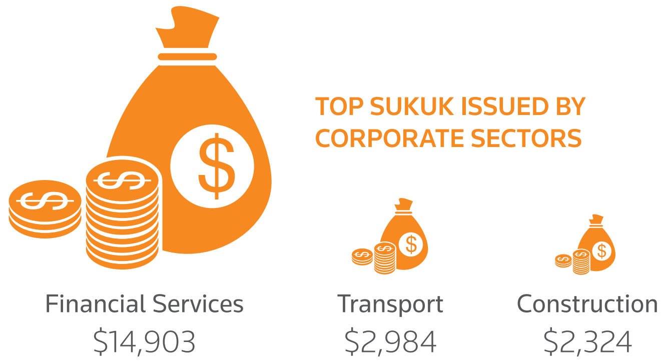
TOP SUKUK ISSUED IN TERMS OF SIZE ($ MILLIONS)

> Both investors and issuers link the plunge in sukuk issuance in 2015 to the drop in oil prices, which they expect to continue to impact the sukuk markets in the near- to mid-term

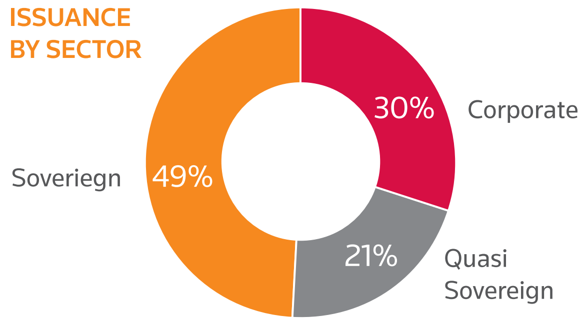
ISSUANCE BY MARKET



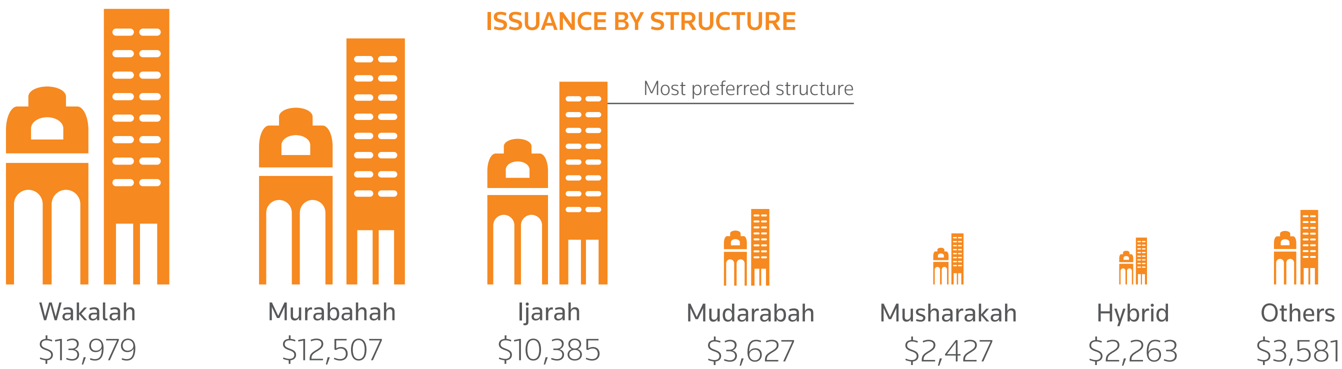
TOP SUKUK ISSUED BY CORPORATE SECTORS



ISSUANCE BY SECTOR



ISSUANCE BY STRUCTURE



> Majority of lead arrangers and issuers prefer sovereign and quasi sovereign

> Financial services is most preferred corporate sector by investors


REUTERS/Issei Kato

Chapter One

Global Market overview

REUTERS/Russell Boyce

Market Opinion

Bond Markets: The equity market's less glamorous sibling

By Michael Bennett, Head of Derivatives and Structured Finance in the World Bank Treasury

MICHAEL BENNETT

Michael Bennett is the Head of Derivatives and Structured Finance in the World Bank Treasury. Among other areas, his team is responsible for the World Bank's transactional work in the area of Islamic finance. Prior to joining the World Bank, he worked in the private sector in the capital markets field in New York, Tokyo and Hong Kong. Michael is a graduate of the Columbia University School of Law in New York.

Global capital markets help governments and companies raise large amounts of capital to meet their funding requirements. Yet, while equity markets often get the most attention, the debt markets, with new issuance totaling around $5.7 trillion in 2014 alone, are bigger, deeper, and more global. Borrowers can tap into debt markets in any part of the world that offers more liquidity, competitive pricing, higher yields, and overall efficiency.

One reason equity markets get more attention is they generally make for better drama. The bond world offers no equivalent to television commentators screaming their opinions about stocks or entrepreneurs becoming overnight billionaires because of a successful IPO. However, debt markets also rise and fall, if in generally smaller increments than stocks, and experience their own type of drama.

A combination of factors, including continuing uncertainty about interest rate increases in the United States, negative interest rates in parts of Western Europe, the regular threat of deflation in Japan, and increasing negative sentiments about emerging markets partly reflected and partly reinforced by the global downturn in commodity prices have made 2015 a particularly dramatic year for most bond investors.

Much of this drama has resulted in higher than normal levels of volatility and unexpected price movements. For instance, just as the European Central Bank was stepping up its program of quantitative easing in April 2015, causing many investors to expect even lower yields on core European government bonds, 10-year German government bond yields rocketed from an intraday low of 0.05% in mid-April to a high of 0.8% in just a few weeks. This surprising move in yields exposed some investors to huge losses. The increased bond market volatility has also been exacerbated by regulatory changes implemented in the wake of the global financial crisis that have made it more onerous for banks to trade bonds, reducing market liquidity substantially.

Not surprisingly, the global sukuk market has not been immune from these difficulties. After many years of significant expansion in new issuance, including landmark sovereign sukuk in 2014 from the United Kingdom, South Africa, Hong Kong and Luxembourg, the growth of the global sukuk market slowed in the first half of 2015. This slowdown is attributable partly to the decline in global oil prices that has drained some of the liquidity from the banks in the Gulf region that was previously fueling much of the growth in issuance. As a result, total global issuance of sukuk in 2015 could be less than half of the record issuance volume achieved in 2012.

Some new developments in the bond markets

Although many of the issues that have impacted the global debt markets in 2015 remain unresolved, there are some recent innovations that serve as bright spots in the market. For instance, in response to growing interest from asset managers and retail investors to invest with an impact, there has been a surge in the issuance of green bonds, the proceeds from which are used by issuers to undertake projects that help mitigate or adapt to climate change. Pioneered by supranational issuers such as the World Bank, the market has grown at an exponential pace over the last five years. Now actively tapped by a variety of issuers including municipals and corporates, overall issuance volume exceeded $35 billion in 2014 and is projected to surpass that in the current calendar year. A successful outcome to the COP21 meetings in Paris in December has the potential to bring even greater attention to this part of the debt markets.

Structured note issuance has also remained strong in many markets around the world. Although highly complex structures, like certain leveraged CDOs, were vilified as one of the causes of the financial crisis and have largely disappeared from the market, in their place simpler structures have gained in popularity. The low interest rates that have been prevailing in most markets have made structured notes one of the few available sources of yield in the bond market.

A recent area of interest has been in the market for Social Impact Bonds (SIBs). A SIB is a "pay-for-performance" or "pay-for-success" contract that can be structured in different ways to address a defined social or environmental problem.

SIBs are a new approach to public finance where private investors provide up-front capital to fund social programs that, if successful, will generate savings for the government. If the programs are effective at meeting pre-determined targets, then the private investors are compensated, sharing in the savings they helped the government generate.

On the other hand, if the social programs do not meet the targets, the investors will suffer a loss, corresponding to the benefits not received by the government due to the failure of the program. While issuance volumes have been insignificant so far, there is real potential for these products to offer above market, uncorrelated returns to investors that are willing to risk some of their capital for a social cause.

CONCLUSION: RESILIENCE IN THE FACE OF HEADWINDS

With equity markets off their all-time highs in most markets, most institutional and retail investors face a conundrum. Signs of a recent slowdown across both the developed and emerging markets indicate that equity markets may not provide the same returns as they have over the last few years. At the same time, fixed income investors continue to confront historically low global interest rates, which combined with any eventual rise in interest rates will adversely affect the value of their holdings. Despite these headwinds, bond markets continue to grow and to evolve with innovations like green bonds, new types of structured notes and SIBs.

"Signs of a recent slowdown across both the developed and emerging markets indicate that equity markets may not provide the same returns as they have over the last few years."

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Fixed Income Market Outlook

Fiscal gap widens and tightening cycle in FY16 as global economy continues to moderate

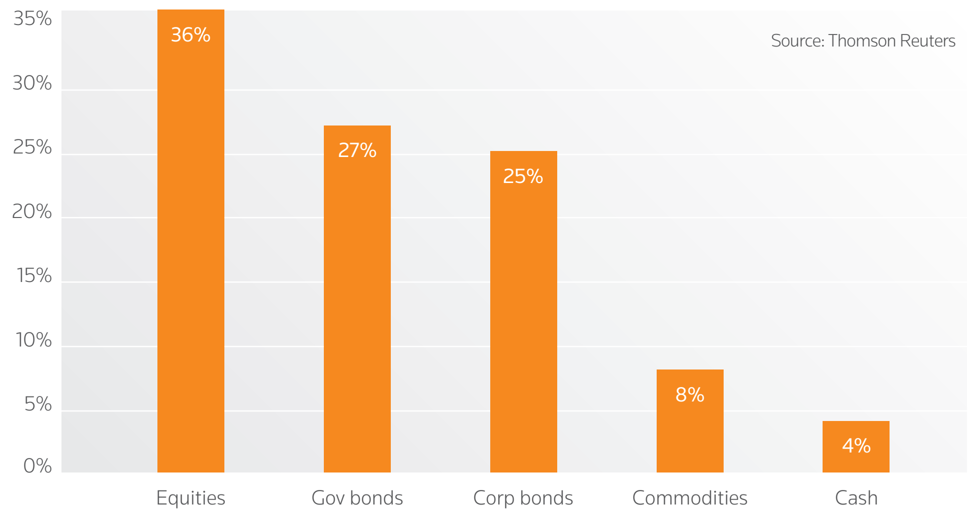
Investors remain cautious and uncertain about the economy in 2016. Concerns persist over the slowdown in China's economy, lingering low oil prices, and the U.S. Federal Reserve hiking interest rates, which looks very likely to happen soon.

Other governments, treading cautiously, may also change their policies to shield themselves against market and economic uncertainty. The spiral is likely to unfold, as the fixed income market in 2016 is not only dependent on the Fed's decision to increase interest rates, but also on the actions of other central banks following suit.

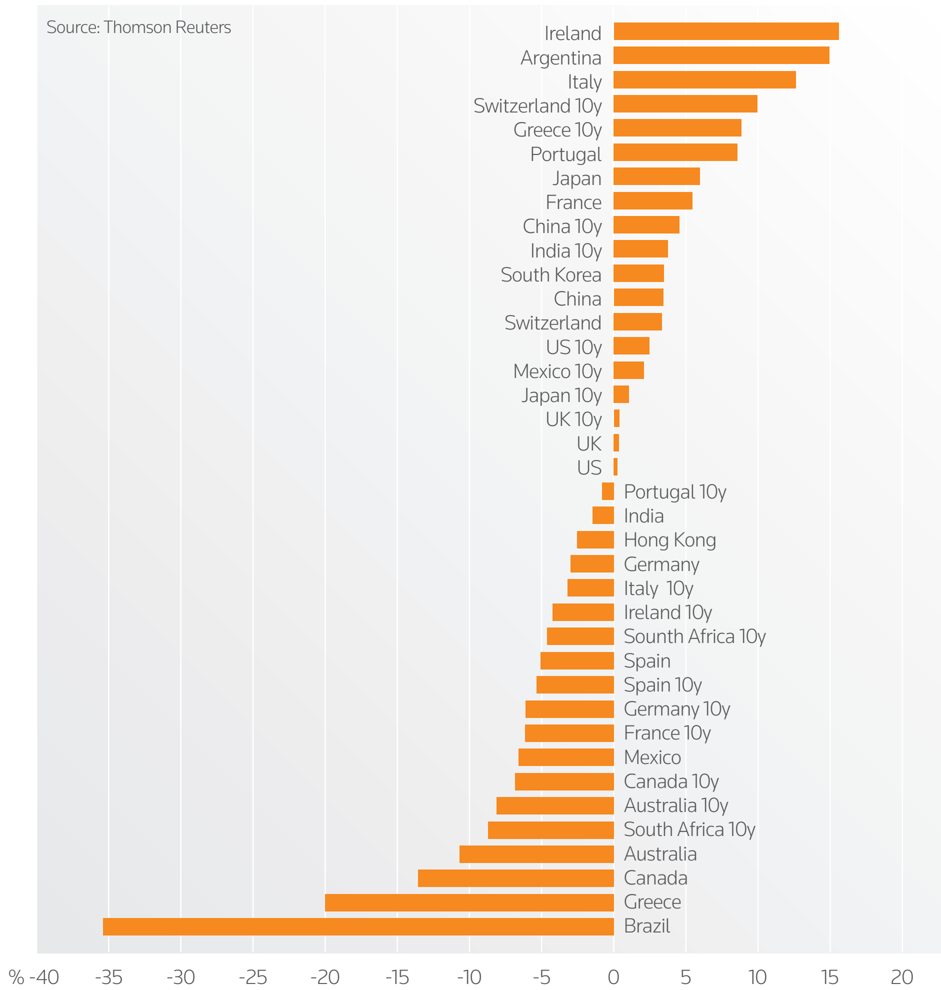
Significantly for Islamic markets, there are also growing concerns over oil-producing countries' difficulties to meet their fiscal deficit targets in 2016. The concerns are most pertinent for the GCC countries; analysts predict that oil prices will continue to remain low.

Some of these GCC governments which face large budget deficits are expected to reduce subsidy programmes and issue more conventional bonds and/or sukuk. Whether these governments opt for sukuk or conventional bonds is dependent on each instrument's cost of funding as well as more strategic considerations, such as sovereigns taking the lead to kickstart their local Islamic capital markets in order to grow their respective Islamic finance industries, at the same time attracting Shariah-sensitive capital.

GLOBAL ASSET ALLOCATION – ACCOUNTS FOR OVER 95% OF GLOBAL GDP



EQUITIES AND BONDS TOTAL RETURN (USD) INDEX



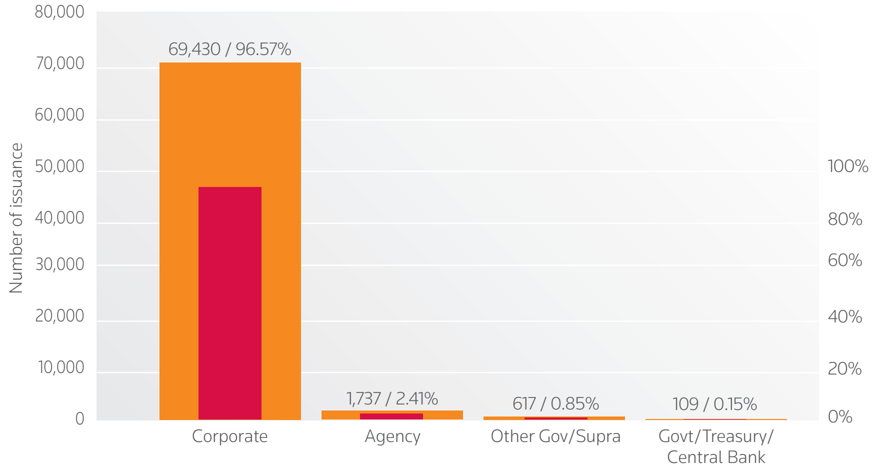
Corporates relied on capital markets for funding in 2015, but liquidity is drying up

As of September 2015, the Eurobond market reached a valuation of $71.92 billion. Unlike international sukuk, the Eurobond market enjoys a diversified pool of currencies, providing numerous options for investors depending on their investment strategy. Interest rates remained low throughout 2015 in an attempt to support households and businesses finance new spending and help support the prices of many other assets. However, borrowers faced a growing resistance from banks to lend money. This phenomenon, as expected, led corporates to tap into the capital markets for liquidity, causing corporate bonds to grow considerably in 2015.

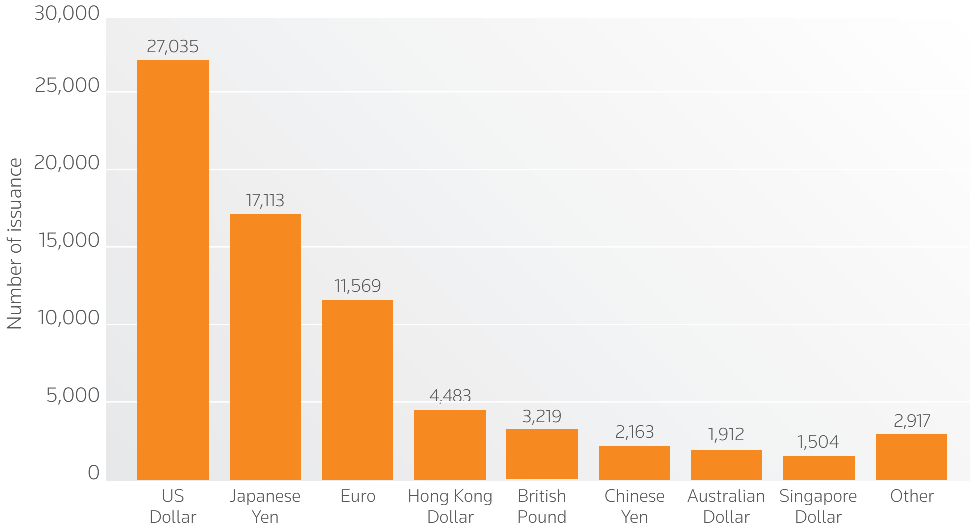
Nonetheless, recent liquidity shortage remains a concern in the corporate bond market. While corporate bond trading volumes remained high, bonds held by banks are declining as regulatory requirements are discouraging banks from stockpiling.

Consequently, most of the burden is shifted on to asset managers, insurance companies and ultimately investors. Policymakers are introducing new rules to improve market liquidity and ease the reliance on banks for cash. Meanwhile, the European Union is also considering adjusting its corporate funding rules in the capital markets, particularly regarding non-equity securities such as corporate bonds. These new proposed rules suggest an annual 'universal registration document' for frequent bond issuers, which aim to reduce costs for corporates regularly issuing bonds.

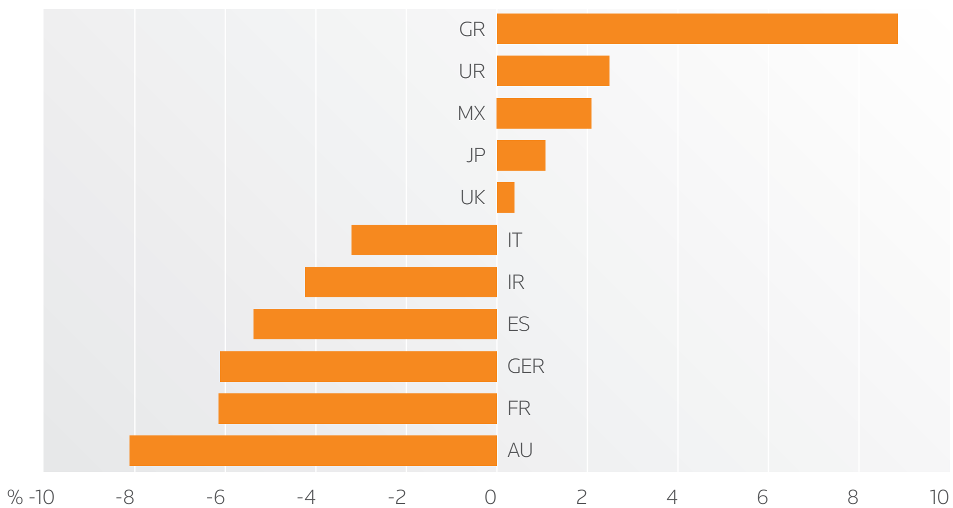
EUROBONDS ISSUE TYPE – JAN - OCT 2015



EUROBONDS PRINCIPAL CURRENCY – JAN - OCT 2015

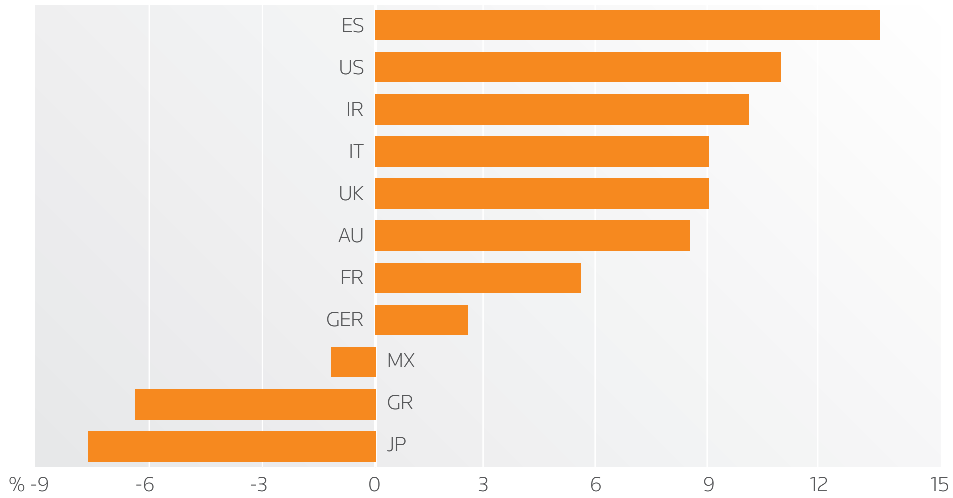


GOV BOND RETURNS IN 2015 – TOTAL RETURNS IN US DOLLARS

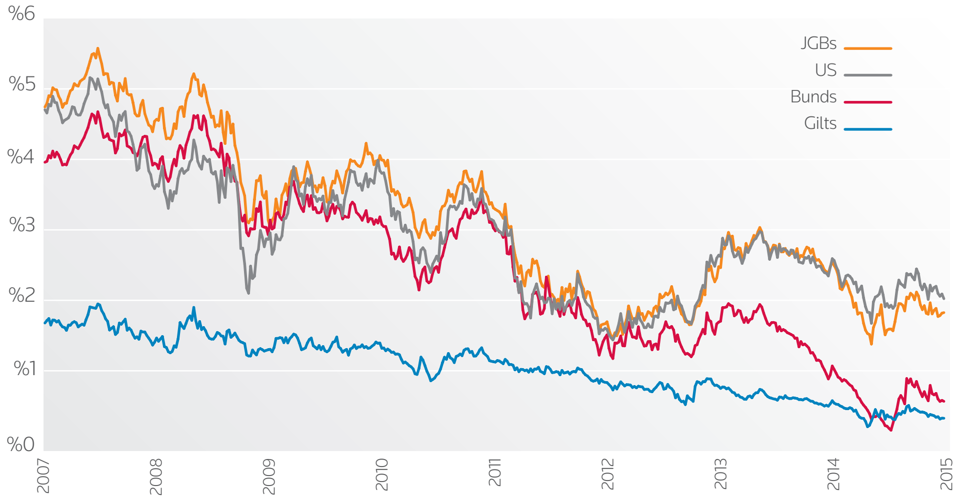


Eurobond – Government

GOV BOND RETURNS IN 2014
TOTAL RETURNS IN US DOLLARS

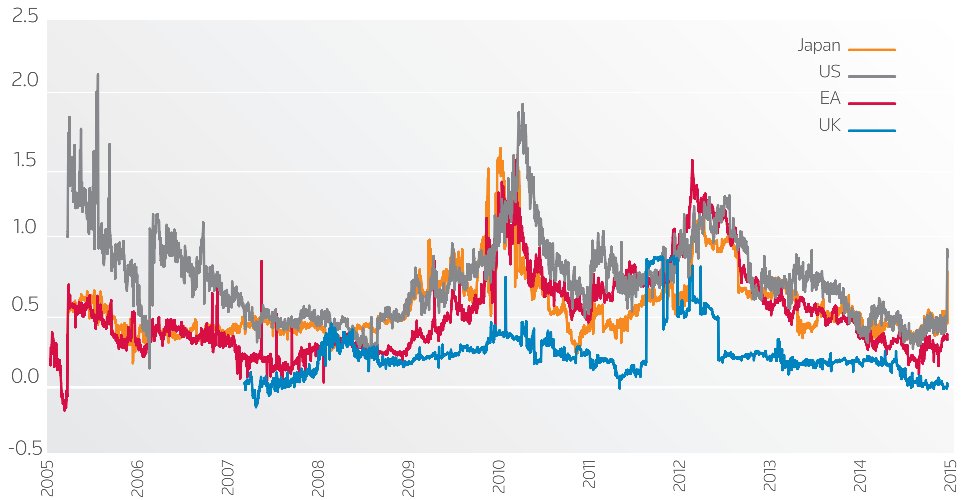


TEN-YEAR GOVERNMENT BOND YIELDS

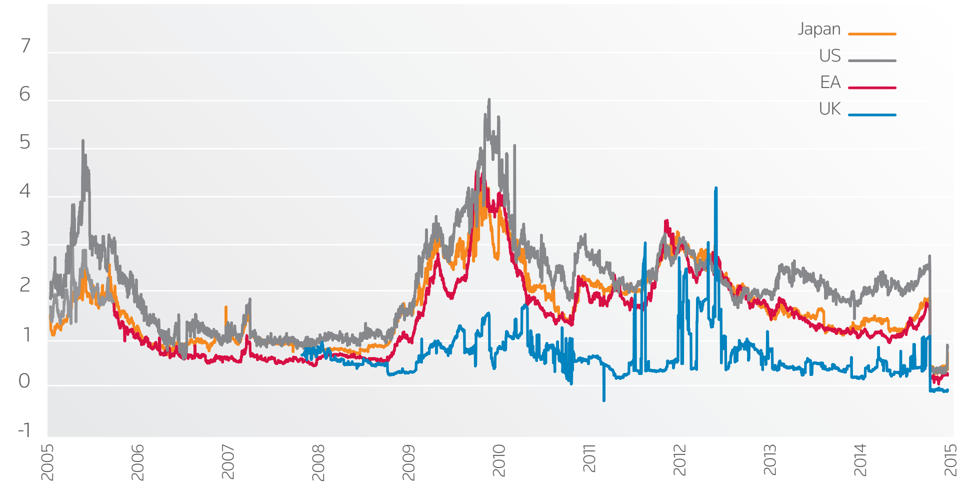


Eurobond – Corporate

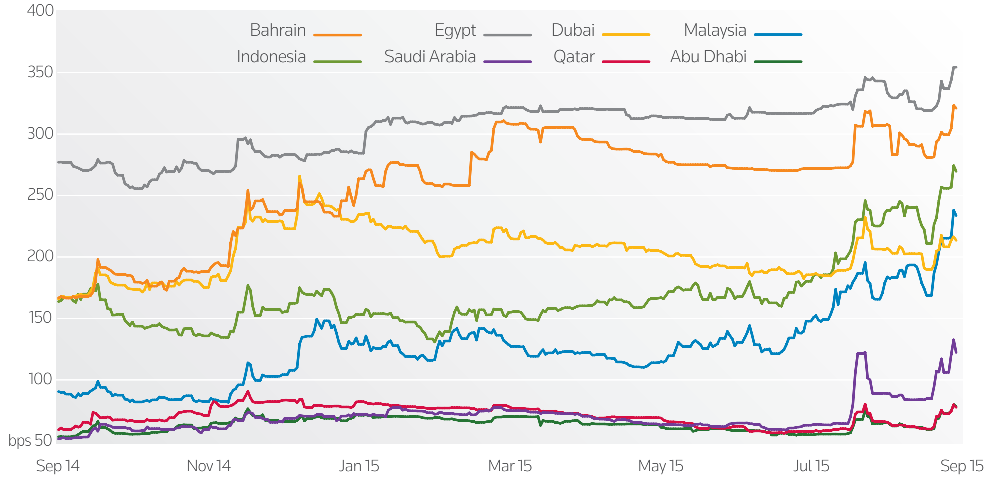
AAA CORPORATE BOND SPREADS
PERCENTAGE POINTS OVER GOVERNMENT BONDS



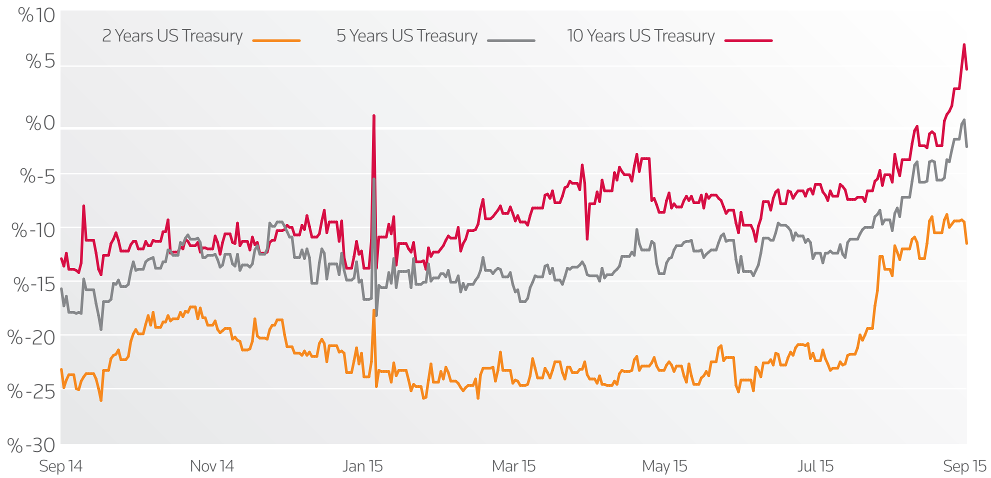
BBB CORPORATE BOND SPREADS
PERCENTAGE POINTS OVER GOVERNMENT BONDS



CREDIT DEFAULT SWAP (FROM Q3 2014 TO Q3 2015)

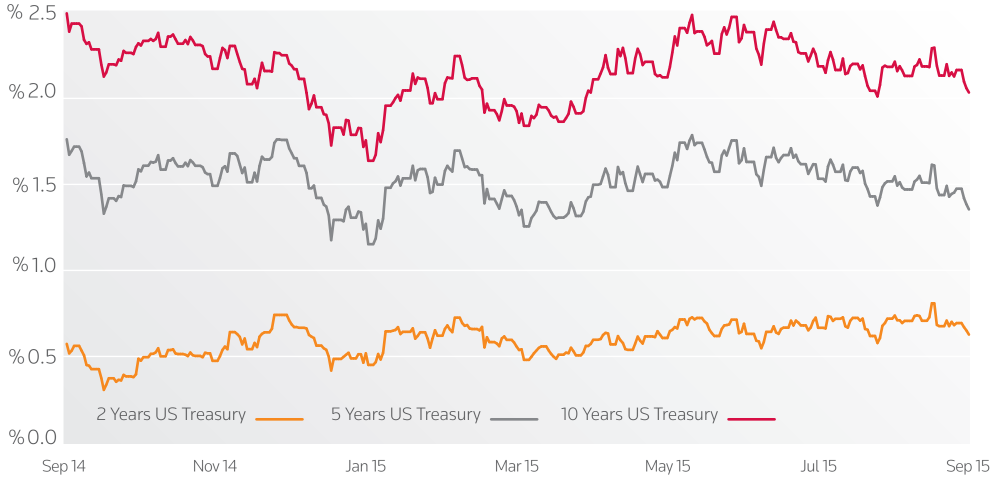


ASSET SWAP SPREADS (FROM Q3 2014 TO Q3 2015)

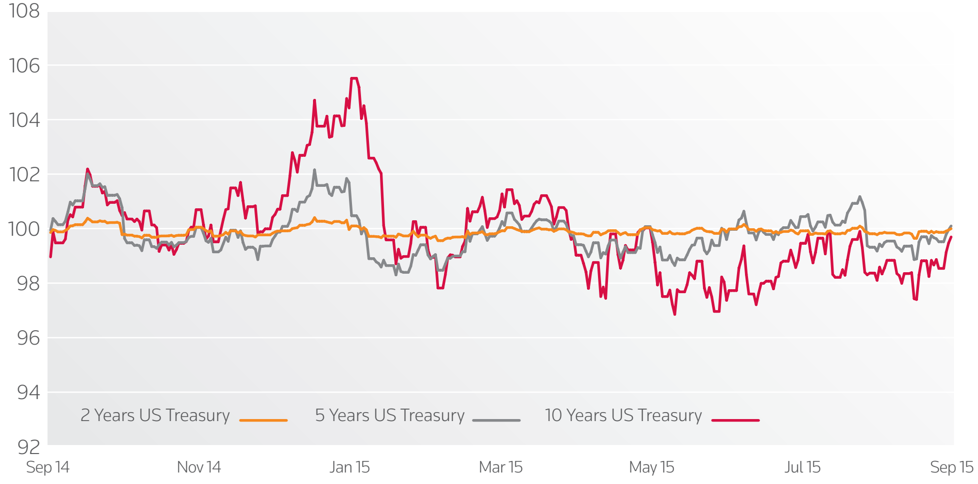


“...recent liquidity shortage remains a concern in the corporate bond market. While corporate bond trading volumes remained high, bonds held by banks are declining as regulatory requirements are discouraging banks from stockpiling.”

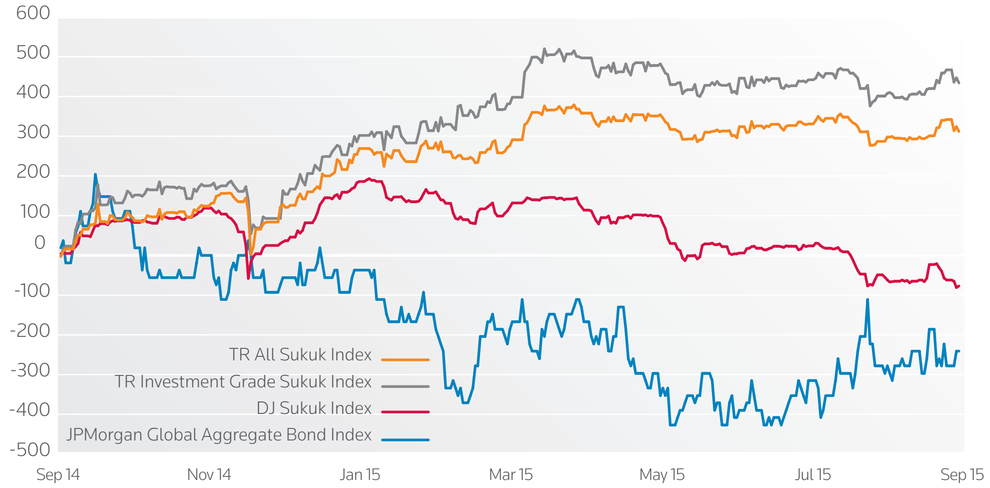
US TREASURY MID-YIELDS (FROM Q3 2014 TO Q3 2015)



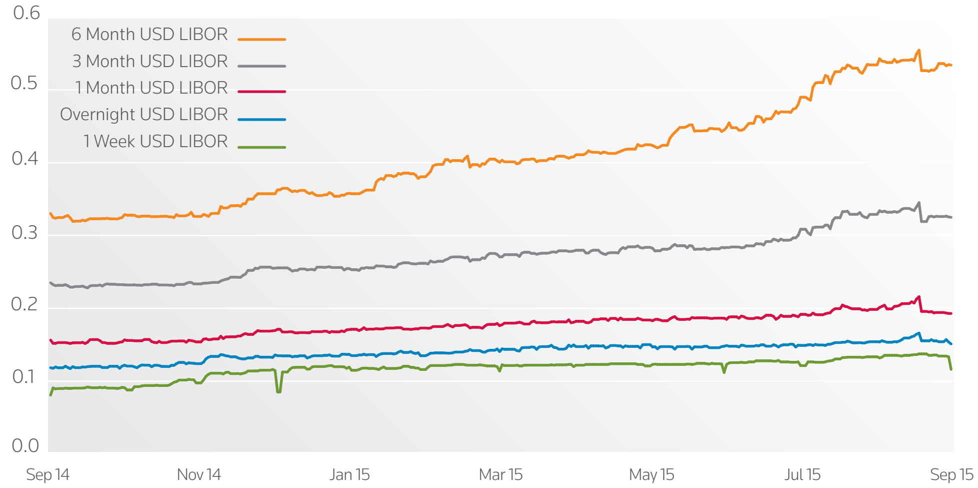
US TREASURY MID-PRICES (FROM Q3 2014 TO Q3 2015)



BOND AND SUKUK INDICES CUMULATIVE GROWTH (FROM Q3 2014 TO Q3 2015)



LIBOR RATES (FROM Q3 2014 TO Q3 2015)



Chapter Two

Global Sukuk Market Outlook

REUTERS/Gary Hershorn

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Sukuk Key Milestones Q3 2014 – Q3 2015

2014

OCT

Luxembourg – Issuance
Luxembourg order book over 500 mln euros on 200 mln euros 5-year sukuk, eyes sophomore sukuk

Japan – Pipeline
Japan's JICA eyes Jordan sukuk

NOV

USA – Issuance
World Bank-linked IFFIm raised $500 mln 3-year sukuk

DEC

Kenya – Pipeline
Kenya announced plan to issue its debut sukuk in 2015/16 financial year

2015

JAN

Tunisia – Issuance
News of Tunisia delaying sukuk issue until third quarter of 2015

Azerbaijan – Pipeline
Azerbaijan's biggest bank plans $200-$300 million sukuk in 2015

Bangladesh – Regulation
Bangladesh central bank launched weekly sukuk issues as liquidity tool

FEB

Pakistan – Regulation
SECP approved sukuk regulations released

UAE – Pipeline
Abu Dhabi Islamic Bank plans subordinated sukuk in Malaysia

Indonesia – Regulation
Indonesia plans to use state goods and services as underlying assets to boost volumes

MAR

UK – Issuance
UK export credit agency guaranteed Emirates sukuk, the first of its kind

UAE – Pipeline
Plans to debut green energy sukuk by Dubai Supreme Council of Energy (DSCE)

Oman – Pipeline
Oman to issue first sovereign sukuk (subscription opened in Oct 2015)

UAE – Issuance
UAE emirate Ras al-Khaimah launched $1 bln sukuk

G20 – Pipeline
News of G20 considering sukuk for infrastructure financing

APR

Kazakhstan – Regulation
Kazakhstan adopted Islamic finance laws and eyes first sovereign sukuk

MAY

Hong Kong – Issuance
Hong Kong plans sophomore sovereign sukuk offering

Malaysia – Issuance
Khazanah launched Malaysia's first social impact sukuk

JUN

Pakistan – Issuance
Pakistan's K-electric sold country's largest corporate sukuk

Brunei – Pipeline
Brunei plans long-tenor sukuk in "very near future"

JUL

Kyrgyzstan – Regulation
Kyrgyz government agreed to introduce sukuk

South Africa – Regulation
South African government to allow listed companies for the issuance of sukuk through recent tax law amendment

UAE – Pipeline
Dubai planning new sukuk channels as listings top other centres

Kuwait – Regulation
Kuwait preparing sukuk legislation to help finance budget

Ivory Coast – Pipeline
Ivory Coast announce plan to issue debut 150 billion CFA sukuk

AUG

Tunisia – Pipeline
Tunisian corporates plan sukuk as Islamic finance rules are finalized

SEP

USA – Issuance
World Bank's IFC issued $100 mln sukuk

USA – Pipeline
World Bank-linked IFFIm issues second sukuk

Market Opinion

Sukuk: with less liquidity, can issuers still play?

By Arsalaan Ahmed, Head of capital financing – Barwa Bank

ARSALAAN AHMED

Head of Capital Financing

Arsalaan is a sukuk specialist with c. 12 years of experience in Financial Services & Islamic Banking. He joined Barwa Bank in October 2013 from HSBC where he played a lead role in developing the Islamic Debt Capital Markets & Wholesale Banking platform. He has originated and executed multiple sukuk transactions across the Middle East and Asia notably including the first public sukuk related to Makkah development in 2008 and more recently the first Vaccine Sukuk and first non-OIC sovereign sukuk issuance (the UK Sovereign Sukuk). Over the past 5 years he has also advised government bodies in Europe, Asia and Africa in setting up Islamic finance and developing a roadmap to issuing sukuk.

He is a graduate from University College London and has a Master's Degree from the University of Bristol.

Although the oil price drop began in late 2014, the start of 2015 saw cornerstone sukuk investors keen to see supply. As the year went on, the appetite of these mainly GCC-based investors started to change. This occurred as liquidity from the banking sector was pulled out. Government and state-owned entities, which are the main supply of USD funds to banks, pulled out money from the system to meet budget needs as the mainstay revenue declined. By the second half of 2015, the bank market was seeing cost of funding rise across the board and bank bidding for deposits became increasingly more aggressive. As such, it was not just capacity for sukuk investment that was impacted, but also yield requirement.

Compounding this was volatility in the equity markets, currency markets, and conventional bond markets. Various factors, (see 'Precarious Prospects' article in this report written by Sulaiman Moolla) primarily money into Emerging Markets credit from conventional investors, was also receding into safer havens. As such, the sukuk investor base has been hit on both sides of the investor spectrum.

So what does this generally mean for issuers?

The good news is that the sukuk market is still open, yet certain fundamentals remain. There is still a lack of supply and sukuk investors are still able to anchor a transaction such that it can buck conventional trends and give market execution comfort to improve probabilities of success.

Abu Dhabi Commercial Bank had to pull a conventional USD issuance from the market due to poor market conditions yet in similar market conditions (as this article is being written); Qatar International Bank announced a deal roadshow for a USD Sukuk. Their confidence is not bravado but experience from an old time issuer of sukuk on how the sukuk market behaves differently from the conventional bond market -- Investors will be there for a good name.

So more specifically what does it mean for issuers?

For issuers that have very high ratings and need significant amounts, it is likely they will be looking at paying up for investment. For unrated or sub-investment grade, there is uncertainty and will depend on the story and what is trying to be achieved.

The market will be there for some and not others. For investment grade issuers the market is available as usual but transactions will have to be managed carefully. For those where there is a market, appointment of arrangers that are willing to directly support transactions is increasingly important to give the transaction strength through a tougher market environment.

Geographically, well known GCC and Asian names will likely be favoured but also those from 'safer' and more stable markets will certainly get a good look in. Others will likely struggle. By type, sovereigns and financial institutions will likely get support. This is important as it is likely that both sovereigns and GCC will lead the charge in issuances in 2016, similar to what we have seen in 2015, particularly in the second half of the year.

For arrangers, the market will also be more competitive, or at least should be on a rational basis. Issuers should be demanding more from arrangers, more direct transaction commitment from international banks and more distribution and general DCM capabilities from local or regional banks (which traditionally have been arrangers mainly for balance sheet commitment). A group of JLMs that work effectively together will ensure better chance of successful execution; also an important factor in a more uncertain market.

There will also be consideration regarding sukuk structure.

In a time where there were high levels of liquidity in the banking market or in the countries' coffers, sukuk issuers were broad and very few were regular. Now it is more likely that issuers will become fewer in number and more regular in issuance.

Structure in the old era was an issue particularly tangible (typically land based) tradable assets that were frequently required. With the potential of more frequent issuances by an issuer (particularly governments) there will need to be a quick and sharp focus on structures that do not require tangible tradable assets but rather intangible tradable assets.

The revival of some of the structures seen out of Saudi state-owned entities, telecoms companies, and also the recent Malaysian sovereign sukuk is in order. These need to be looked at, concepts understood and applied to a broader range of issuers. The importance of arrangers' credentials and credibility in sukuk structuring will likely come back to prominence after what has been a few years of repeat structure and almost a standard in sukuk structures.

New norm

In conclusion, the landscape for sukuk has changed and a new norm is emerging. However, the core driving factors remain the same. As such, sukuk remains a good avenue for the right names to tap into the capital markets. Good advice and well-structured and managed transactions are ever more important, as such choice of arrangers will be critical for issuers.

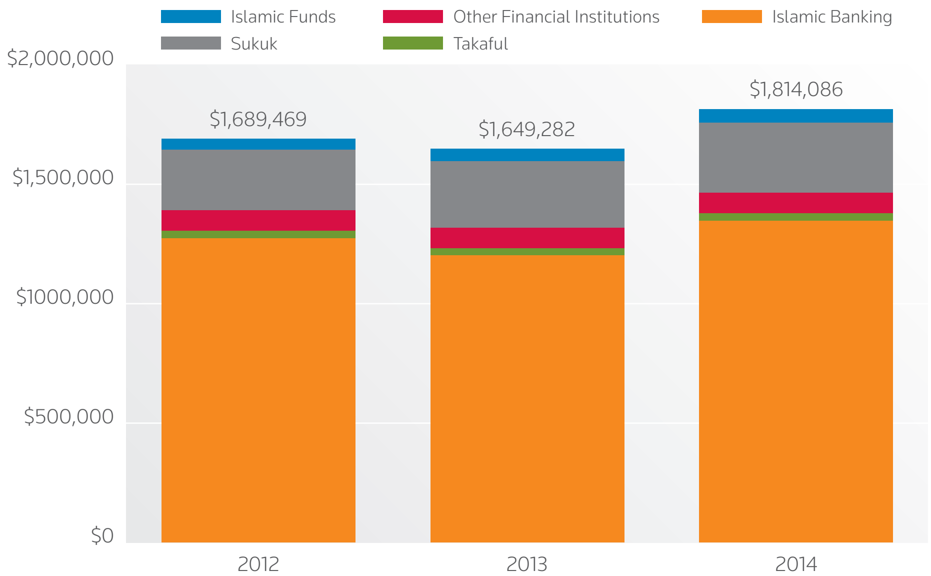
REUTERS/Mike Segar

"Good advice and well-structured and managed transactions are ever more important, as such choice of arrangers will be critical for issuers."

2014 Recap

Beyond tradional markets

ISLAMIC FINANCIAL QUANTITATIVE DEVELOPMENT – TOTAL ISLAMIC FINANCE ASSETS (USD MILLION)



The **ICD Thomson Reuters Islamic Finance Development Indicator** is a composite weighted index that measures the overall development of the Islamic Finance industry by providing an aggregate assessment of the performance of all its parts, in line with the objectives of Islamic principles.

The **sukuk sub-indicator** value is the outcome of 7 metrics: number of sukuk issued and outstanding, volume of sukuk issued and outstanding, number of listed sukuk, number of rated sukuk and bid/ask spread for each country within the IFDI universe that are normalized then averaged to reach to the global sub-indicator value. More on IFDI's background insights can be viewed at **www.zawya.com/islamic-finance-development-indicator/**

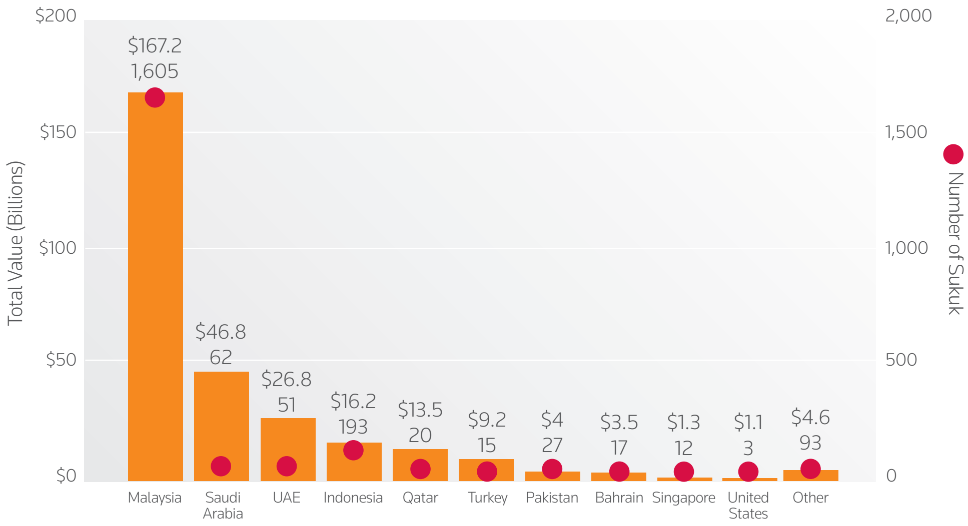
SUKUK IS THE SECOND LARGEST AND SECOND FASTEST GROWING ASSET CLASS IN ISLAMIC FINANCE

Total global Islamic finance assets reached US$1.8 trillion in 2014, according to the ICD-Thomson Reuters Islamic Finance Development Indicator (IFDI). Sukuk made up US$295 billion, or 16% of total Islamic finance assets. Islamic banking is the biggest sector (US$1.3 trillion, or 74%). Other Islamic financial institutions trail sukuk (US$84 billion, 5%), followed by Islamic funds (US$56 billion, 3%) and takaful (US$33 billion, 2%).

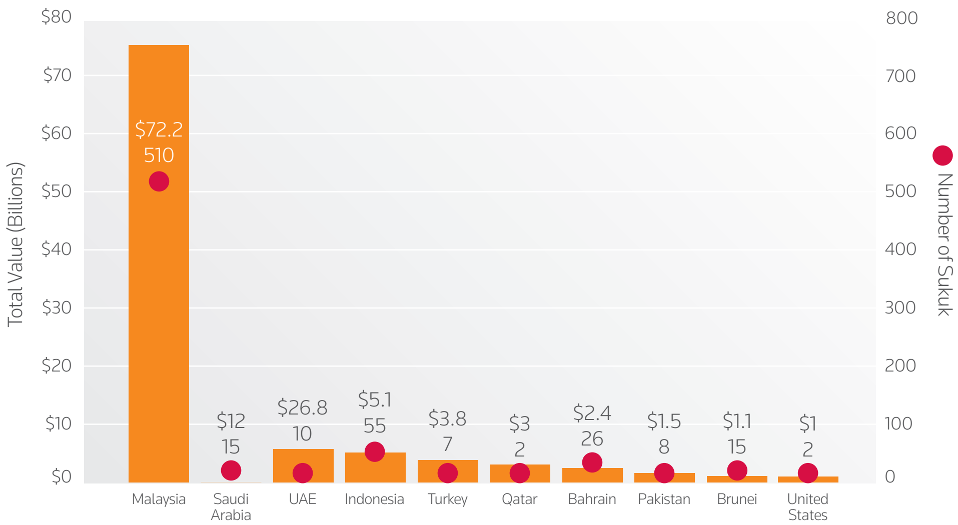
Sukuk had a CAGR of 8.3% since 2012, which is 2 times higher than the CAGR for overall Islamic finance industry assets (3.6%). However, sukuk is not the fastest-growing sector -- it trails Islamic funds which enjoyed a CAGR of 9.8% since 2012.

> *"Sukuk had a CAGR of 8.3% since 2012, which is 2 times higher than the CAGR for overall Islamic finance industry assets (3.6%). However, sukuk is not the fastest-growing sector -- it trails Islamic funds which enjoyed a CAGR of 9.8% since 2012."*

GLOBAL SUKUK OUTSTANDING – TOP 10 COUNTRIES – (FYE 2014)



SUKUK ISSUED – TOP 10 COUNTRIES – (FYE 2014)



MALAYSIA CONTINUES TO LEAD

Malaysia is the world's sukuk leader by number of issuances and value of sukuk issued, as well as value of sukuk outstanding. By these 3 metrics there is a substantial gap between Malaysia and second placed Saudi Arabia; these 2 countries lead their respective regions in the global sukuk market --- 70% of the top 10 countries by sukuk issued in 2014 are in Southeast Asia (Malaysia, Indonesia, Brunei) and the GCC (Saudi Arabia, UAE, Qatar, Bahrain).

Total Global Sukuk Volume Outstanding in 2014

US$ 295 billion

Total Global Sukuk Volume Issued in 2014

US$ 114 billion

"Malaysia is the world's sukuk leader by number of issuances and value of sukuk issued, as well as value of sukuk outstanding."

Sukuk Market Overview in 2015

By Volume

The year sovereigns issuances plunged

Total sukuk issued in the first 9 months of 2015 dropped a drastic 38.6% to $48.8 billion from $79.5 billion for the same period in 2014. The 2015 sukuk market is not likely to break the $100 billion mark or surpass the $114.08 billion high in 2013.

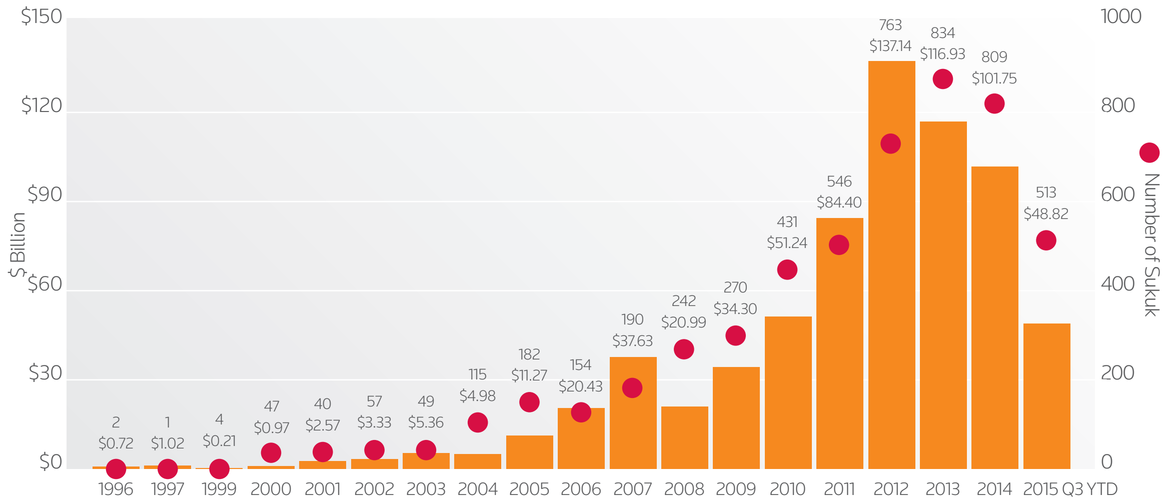
Unlike 2014, the sukuk market was very quiet in 2015 mainly due to the low sukuk issuance in Malaysia and the dearth of new players. Leading up to 2015 there were expectations that oil-exporting countries (particularly those of the GCC) hit by low oil prices would be driven to widen and deepen their sukuk markets to raise funding. These expectations were not met in the first 9 months of 2015.

In addition, Malaysia, the biggest sukuk market, made the decision to stop issuance of short-term sukuk from Bank Negara Malaysia (BNM), the country's central bank. BNM explained that their short-term papers were not entirely reaching local Islamic banks (whose liquidity needs was the primary reason for the short-term papers to begin with) as they were being picked up by a much wider investor base. Moving forward the central bank will be using other instruments that would be made available only to these banks to serve their liquidity needs.

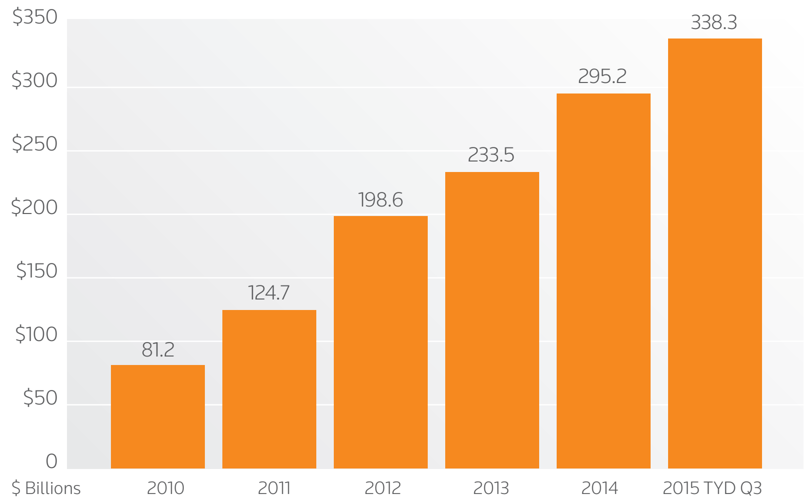
The sukuk market in 2014 was one of the better years in sukuk history for outreach and investor acceptance due to the number of non-Muslim and non-traditional issuers that went to market such as the UK, Senegal, Maldives and South Africa. However, these issuers have not returned in 2015 and the only new issuer is the Omani government which issued its debut sukuk in October 2015.

Global sukuk growth for the first 9 months (2011-2015)		
Period	Sukuk Amount	Growth Rate
YTD Q3, 2015	$48.82 Billion	-50.82%
YTD Q3, 2014	$99.27 Billion	24.50%
YTD Q3, 2013	$79.7 Billion	-26.80%
YTD Q3, 2012	$109 Billion	68.40%
YTD Q3, 2011	$64.7 Billion	48.40%
YTD Q3, 2010	$33.39	Base Year

GLOBAL AGGREGATE SUKUK HISTORICAL TREND
(1996 - YTD Q3 2015)



TOTAL GLOBAL OUTSTANDING SUKUK HISTORICAL TREND
(2010 - YTD Q3, 2015)



By Market Type

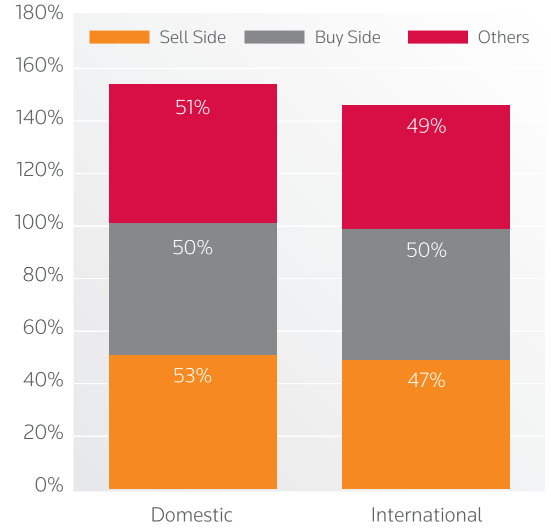
The sukuk market continues to be a domestic market

Total international sukuk issued in the first 9 months of 2015 was $17.4 billion, which represents 34.8% of all sukuk issued for that period. Comparatively, the share of international sukuk for the first 9 months of 2014 was a much lower 21.9%. In contrast the number and value of domestic issues for the first 9 months of 2015 was $32.5 billion. This, however, is a drastic plunge from the value of domestic issues for the first 9 months of 2014, which was $59.7 billion. Total domestic sukuk issued for the whole of 2014 was $75.4 billion. Most domestic sukuk are issued in Malaysia, which has a very active local Islamic capital market. Saudi Arabia, Indonesia, Bahrain, UAE and Brunei are some of the other key local markets.

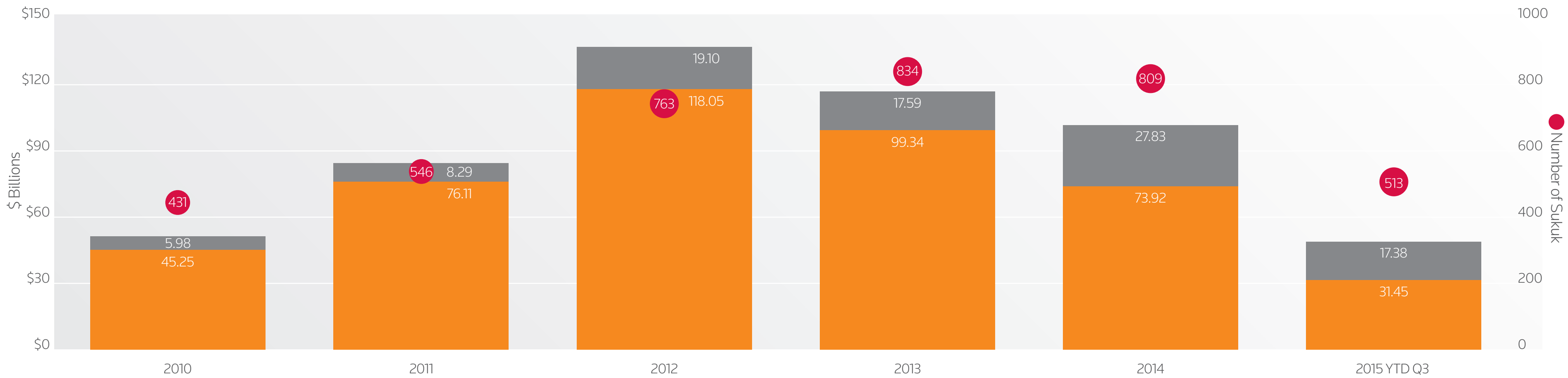
Despite international sukuk attracting global demand, our Sukuk Survey finds that market players still favour domestic markets, and investors have a preference for domestic over international issues (53% v 47%). Traditionally, most issuers fulfil their funding needs through local currencies, which are less expensive to hedge and are cheaper and faster to issue. But with Malaysia not offering short-term sukuk, the market could be in for a fundamental change and issuers would need to find alternative markets for sukuk investments. The environment will prove to be challenging for investors as there are very few liquid sukuk markets. In turn, the demand for sukuk would increase and liquidity and tradability would go down as investors would hold onto their sukuk investments for longer due to the lack of supply.

Our Sukuk Survey finds that investors are indifferent between international and domestic sukuk for their investments, while issuers significantly prefer domestic papers (53%). Other key market players also believe domestic sukuk are more attractive.

TYPE OF ISSUE: INTERNATIONAL VS. DOMESTIC



GLOBAL SUKUK HISTORICAL TREND BREAKDOWN BY MARKET OF ISSUANCE (2010 - Q3, 2015)



By Region & Country

13 jurisdictions tapped the sukuk market in the first 9 months of 2015 compared to 19 in 2014

There were 2 notable downsides to the global sukuk market in 2015. Firstly, leading up to 2015, there were expectations that the sukuk market would continue to grow by number of new issuers but these expectations were not met. Secondly, Malaysia's central bank announced it would stop offering short-term domestic sukuk.

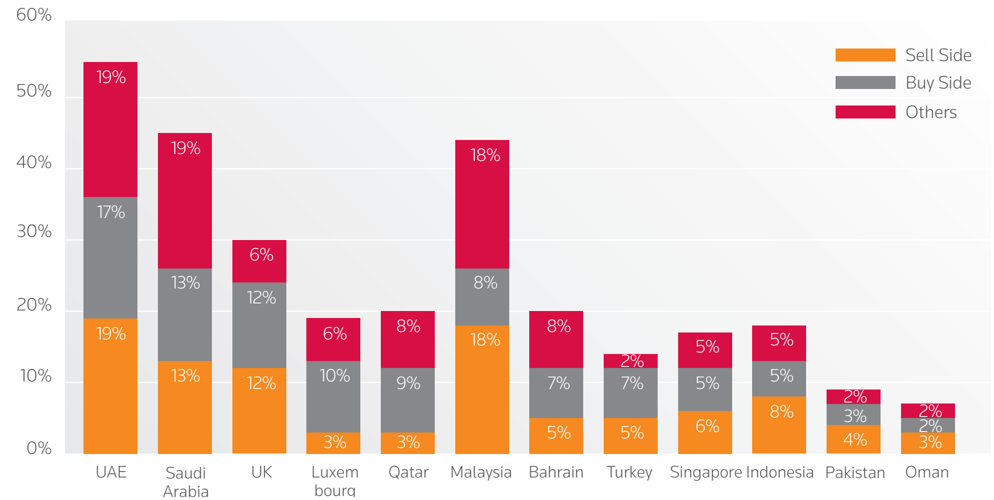
In the first 9 months of 2015 Malaysia issued $24.6 billion sukuk, which is approximately 53% below the level of the first 9 months of 2014 ($52.04 billion). As a result, after years of holding at least 60% market share, Malaysia's total sukuk share dropped from 61.4% in Q3 2014 to 49.1% in Q3 2015. The second largest sukuk issuer, Saudi Arabia, also issued far fewer sukuk; the Kingdom's share plunged by 53.2%. Over the same period Saudi Arabia issued just $5.4 billion compared to $11.5 billion in 2015. Qatar, another active sukuk player in 2014, only issued $0.5 billion compared to a massive $3 billion a year earlier. On a positive note, Bahrain increased its sukuk issuance by 103.6% in Q3 of 2015. Bahrain has been capitalizing on sukuk to fund its budget deficit following the drop in oil prices. Indonesia is another sukuk market that has increased its issuances, by 58.3% in addition to increasing its market share from 5.4% in the first 9 months of 2014 to 14.3% in same period in 2015. There were markets that were not affected by global market conditions such as the UAE, which more or less issued the same amount in the first 9 months of 2015 as in the same period in 2014. In Q3 2015, UAE issued $4.7 billion compared to $4.4 billion.

UK's debut sovereign sukuk was followed by issues from other non-Muslim countries or entities. Three months after the UK's June 2014 issue the following sovereigns and entities all issued in September of the same year: Hong Kong, South Africa, Luxembourg, Japan's Bank of Tokyo-Mitsubishi UFJ, and Goldman Sachs. However, the sukuk market in 2015 has not enjoyed the entrance or introduction of any new non-Muslim sovereigns.

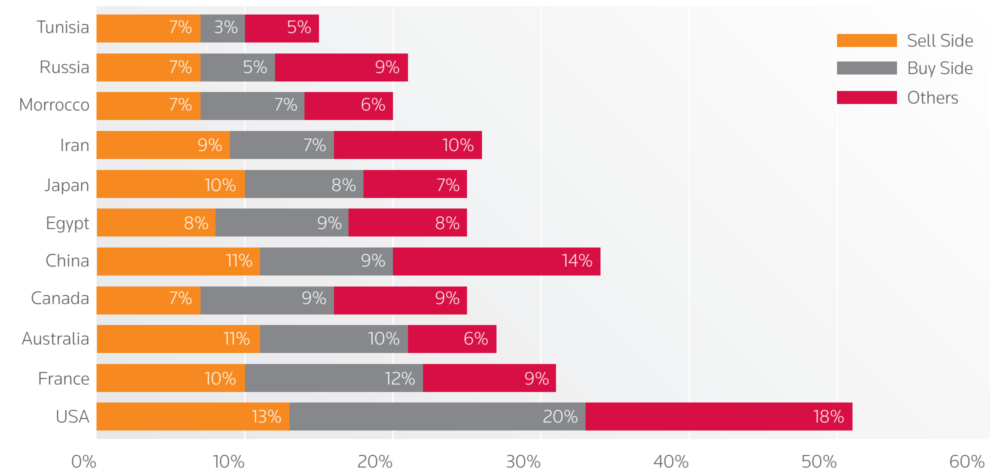
The UK's sovereign sukuk has lifted the visibility of non-OIC issuers. Issuers and investors now prefer countries like the United States, France and Australia for sukuk issuance and investment. Issuers also see China and Australia as second top preferred destinations for sukuk. Investors prefer 3 countries for sukuk investment -- the United States (20%), France (12%) and Australia (10%). Canada is also gaining ground, coming in as 4th preferred country for sukuk issuance and investment.

For the established sukuk markets, our 2015 Sukuk Survey points to a strong preference for UAE and Saudi Arabia as the preferred countries to invest and issue sukuk. Lead arrangers and issuers show a marginally higher preference for UAE over Malaysia (19% over 18%) for sukuk issuance. Investors chose UAE as the top preferred market for sukuk investments at 18%. Other key market players have shown great interest in UAE (19%), Saudi Arabia (19%) and Malaysia (18%) for sukuk issuance and investment.

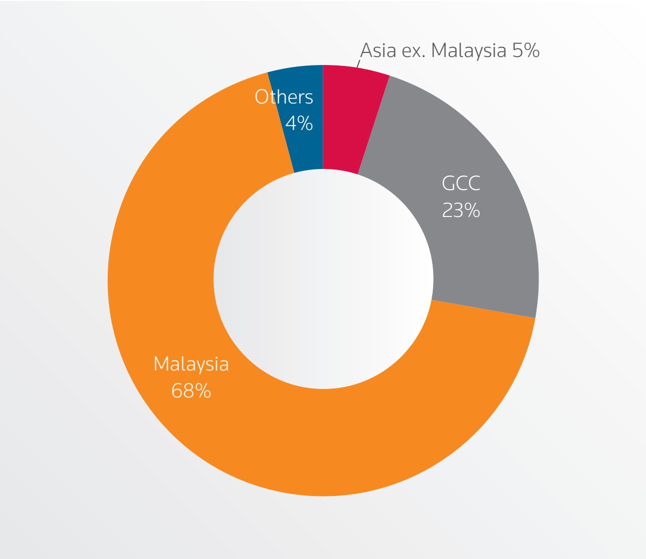
SURVEY FINDINGS – COUNTRY PREFRENCE



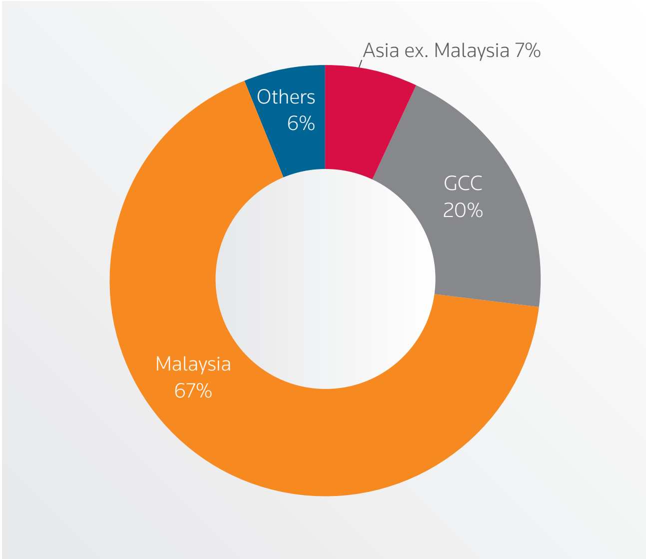
OUT OF THE FOLLOWING EMERGING ISLAMIC FINANCE MARKETS, WHICH ARE THE 5 MOST ATTRACTIVE FOR SUKUK INVESTMENT?



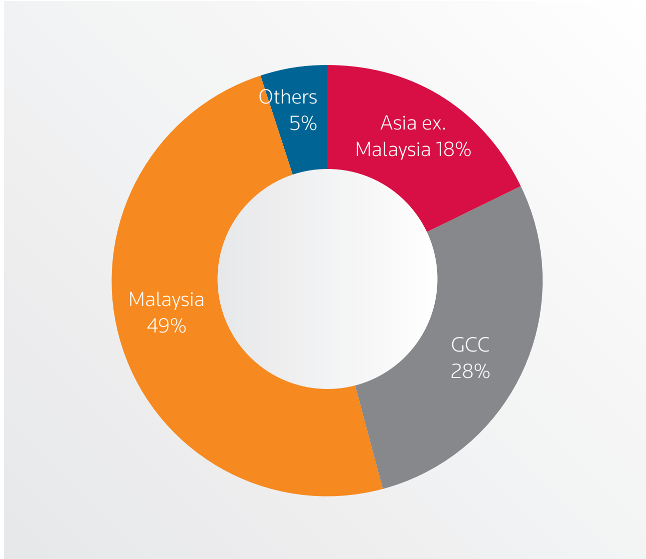
GLOBAL SUKUK BREAKDOWN BY REGIONS 2013



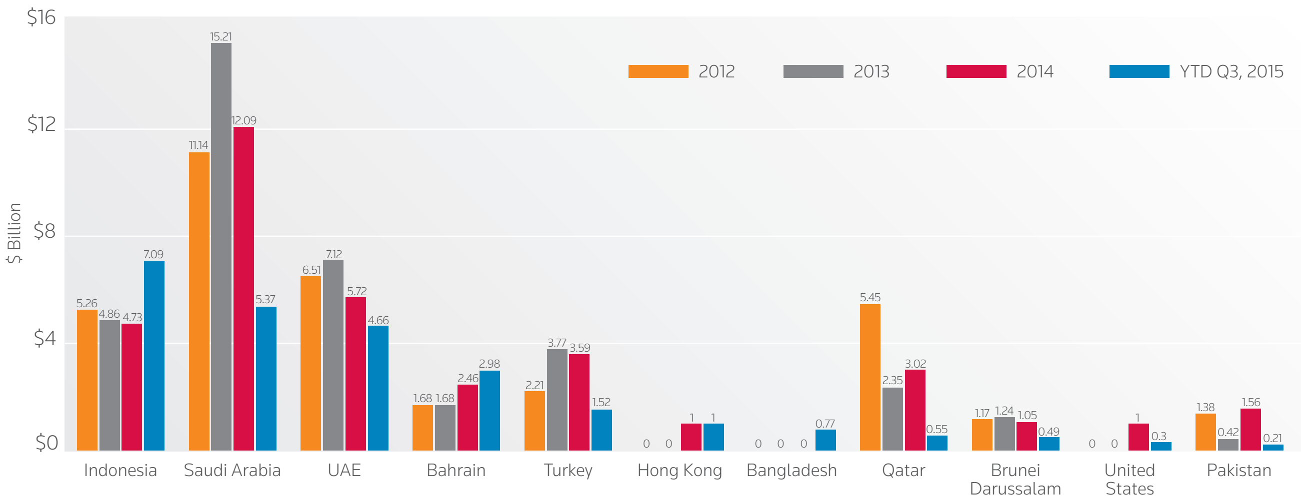
GLOBAL SUKUK BREAKDOWN BY REGIONS 2014



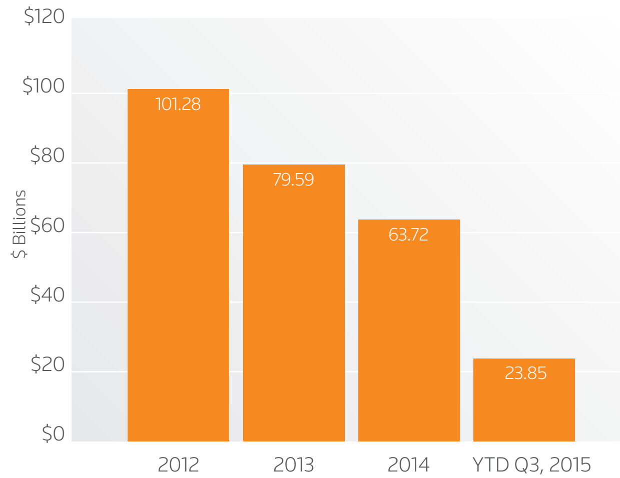
GLOBAL SUKUK BREAKDOWN BY REGIONS Q3 2015



GLOBAL SUKUK HISTORICAL TREND BREAKDOWN BY TOP COUNTRIES EX. MALAYSIA (2012-Q3, 2015)



MALAYSIA SUKUK HISTORICAL TREND BREAKDOWN (2012-Q3, 2015)



By Sector

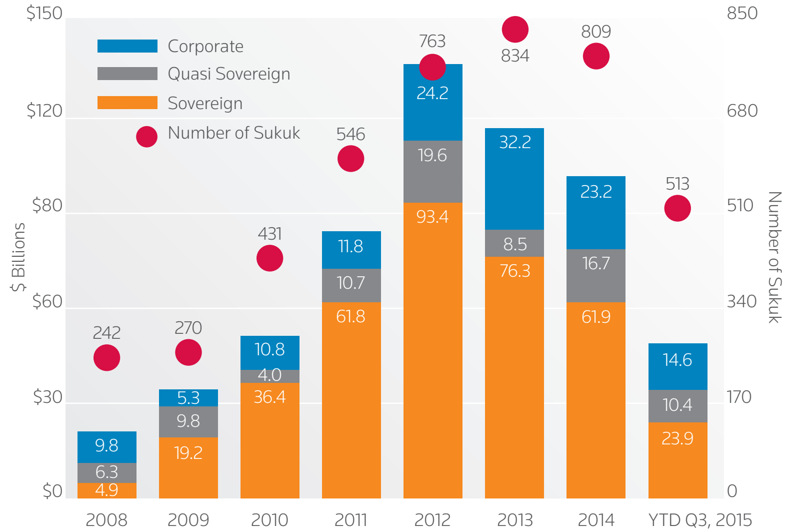
Governments continue to activate markets

The sukuk industry still continues to depend heavily on government issuance to drive markets but there has been a notable drop in sukuk issued by governments. While the drop in sukuk from governments is directly related to Malaysia's decision to stop its issuance of short-term papers (and to a lesser extent the drop in Saudi Arabia's issuance), however other issuers -- corporates and quasi sovereigns -- have also cut back from 2014 levels.

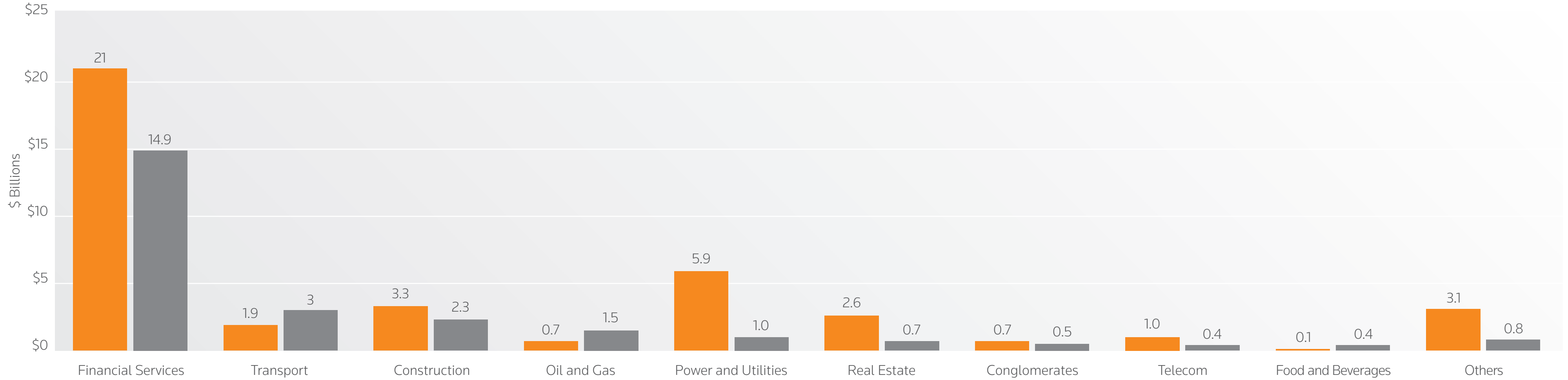
Corporate sukuk was down 27% in the first 9 months of 2015 ($14.8 billion) compared to $20 billion in the same period of 2014. The value of issuance from Malaysian and Saudi Arabian corporates was down by 41% and 41.6%, respectively. In contrast, UAE corporates have been a lot more active compared to 2014, thanks to financials such as Dubai Islamic Bank (DIB), Sharjah Bank, and Noor Bank which together issued $2.75 billion. Emirates Airline issued $913 million to take total corporate issuance in the UAE to $3.7 billion compared to only $1.7 billion over the same period in 2014.

There was also a lower value of quasi-sovereign sukuk in the first 9 months of 2015 -- $10.5 billion compared to $13.2 billion in the same period in 2014. Notably, UAE quasi-sovereigns, which issued $1.2 billion in the first 9 months of 2014 was absent in the same period of 2015, and Saudi Arabia's government-related entities (GREs) only issued $1 billion compared to $4 billion in same period of 2014.

GLOBAL SUKUK HISTORICAL TREND BREAKDOWN BY ISSUER (2010 - YTD Q3, 2015)



GLOBAL CORPORATE SUKUK GROWTH COMPARISON (2014 - Q3 2015)

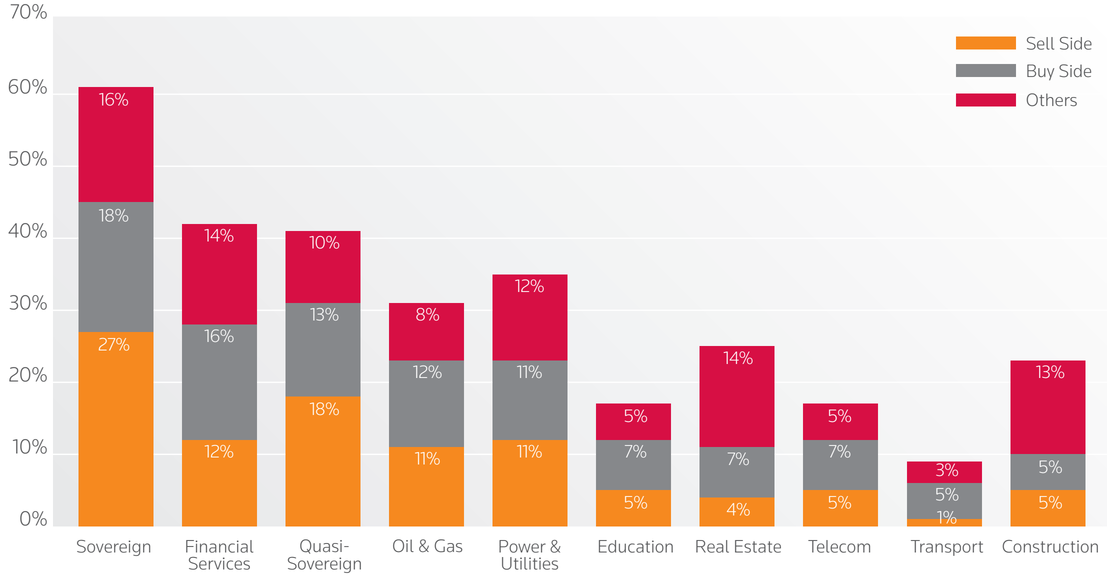


Financial institutions (FIs) continue to lead all corporate issuances in the market for the first 9 months of 2015, followed by Transport, Construction, Real Estate and Conglomerates. The market has also welcomed 2 new sectors this year -- Information Technology and Consumer Goods, both represented by Malaysian companies. These sectors were not represented in 2014.

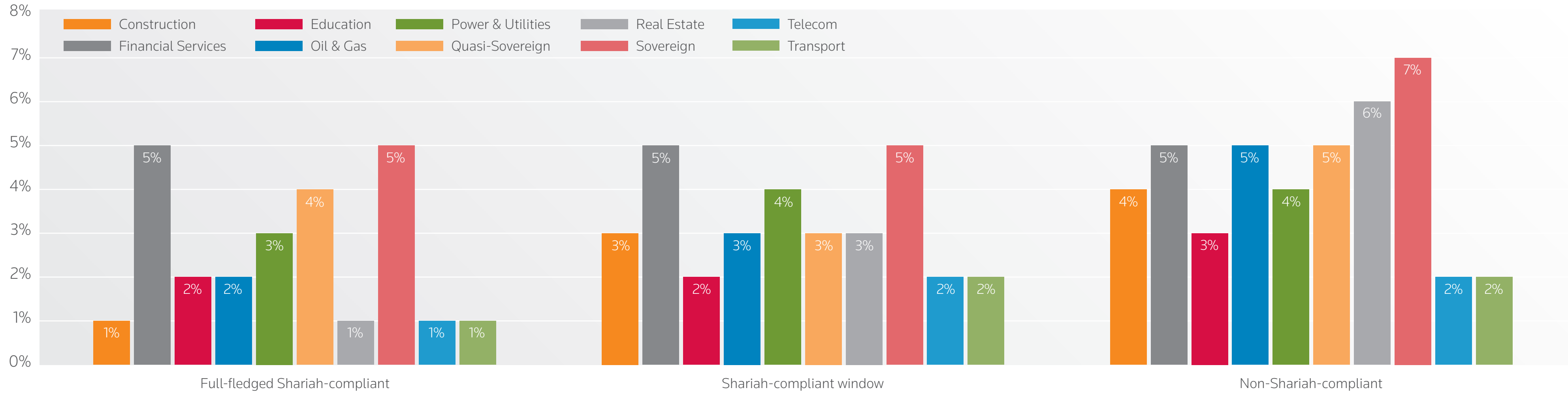
In terms of performance, corporate sukuk by FIs stood at $7.9 billion in the first 9 months of 2015, representing an increase of 8% from the same period in 2014. Interestingly, Food and Beverages stood at $426.6 million, thanks to Almarai which was the only issuer from the F&B industry in the first 9 months of 2015. Transport sukuk were also on the rise and have substantially increased from 2014; they registered an increase of 221.1% to reach $3,010.6 million by the end of Q3 of 2015.

Our Sukuk Survey reveals that the majority of lead arrangers and issuers prefer issuances from sovereigns and quasi sovereigns. Sovereigns are also investors' most preferred sector, with financial services in second place. There is also investor appetite for Oil & Gas, and Power & Utilities. We see room for more sukuk across these sectors. From the survey responses, it is clear that investors consider the quality of papers over returns.

SURVEY FINDINGS – SECTOR PREFERENCE



SURVEY BREAKDOWN – SECTOR PREFRENCE



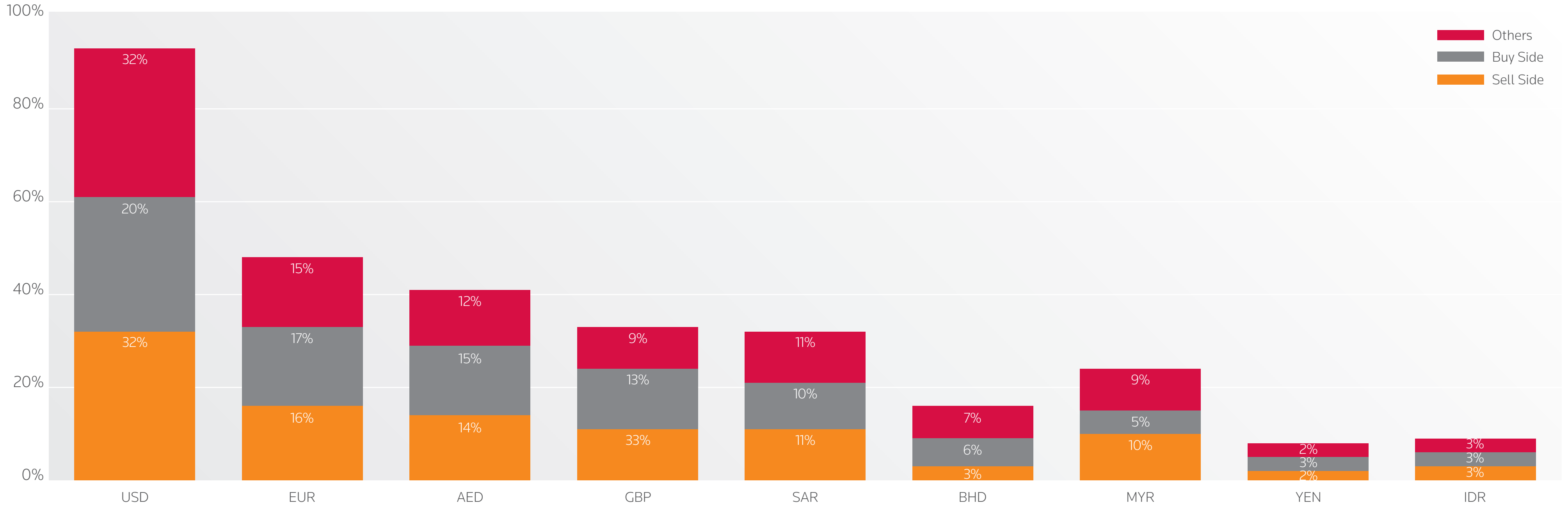
By Currency

Sukuk issued in 12 currencies in 2015 compared to 16 in 2014

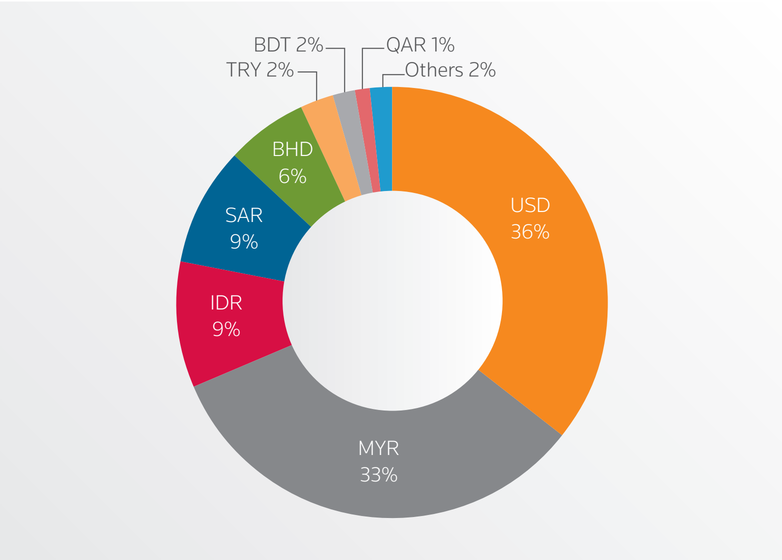
After years of domination the Malaysian Ringgit has been overtaken by the U.S. dollar as the currency of choice for sukuk issuance. This has everything to do with the plunge in Ringgit sukuk rather than any sort of surge in USD issues. In fact USD sukuk did not increase in value. In the first 9 months of 2015, the sukuk issued in Malaysian Ringgit stood at $16.1 billion compared to a much higher $47.9 billion in the same period in 2014, representing a drop of 66%. As we mentioned earlier, the underlying reason is related to the Malaysian central bank cutting back its short-term sukuk issuance. Similarly, the sukuk issued in USD have also dropped although not as drastically as the drop in Ringgit sukuk. Over the course of the first 9 months of 2015, USD sukuk amounted to $17.5 billion compared to $20.9 billion. Sukuk in Indonesian Rupiah have substantially increased by 59% to reach $4.6 billion by the end of Q3 in 2015 compared to $3.1 billion as of end of 2014. The Indonesian market was badly hit by the Asian financial crisis of the late 1990s but the Republic has recovered well, and now attracts the highest foreign direct investment in Southeast Asia.

Bahraini dinar issuances doubled since 2014 reaching $3 billion by the end of Q3 2015. Like other oil exporting countries affected by the drop in oil prices Bahrain has been facing difficulties in meeting its budget. However, Bahrain has been issuing sukuk since the early 2000s both to cover its budget deficit as well as provide liquidity for Islamic financial institutions based in the country. It is worth mentioning that Turkish lira sukuk issuances have increased by 166.5% to reach $1.2 billion. There has been a lot more sukuk activity in the country as opposed to only a single issuance by Q3 of 2014.

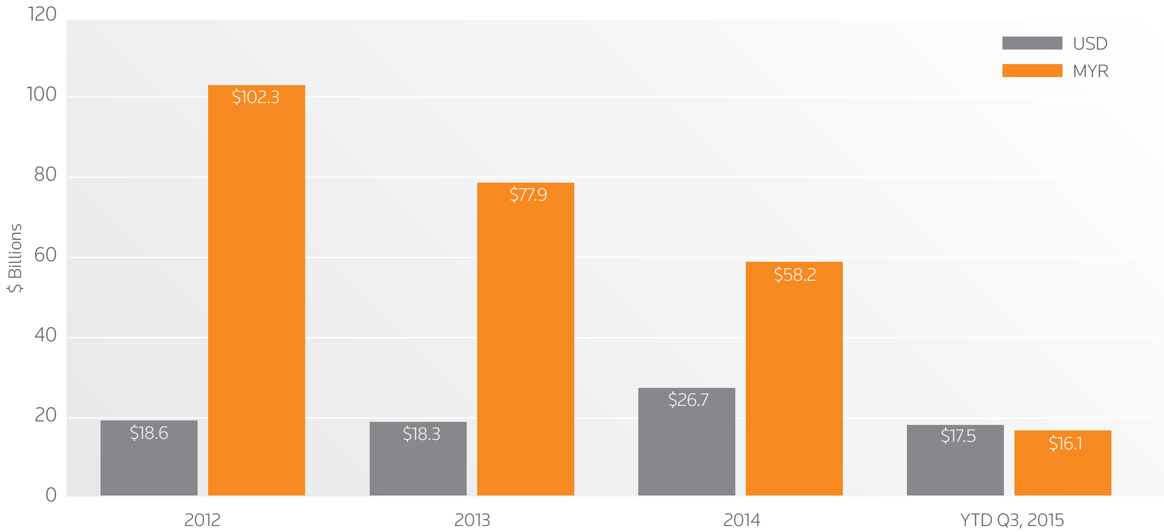
SURVEY FINDINGS – CURRENCY PREFERENCE



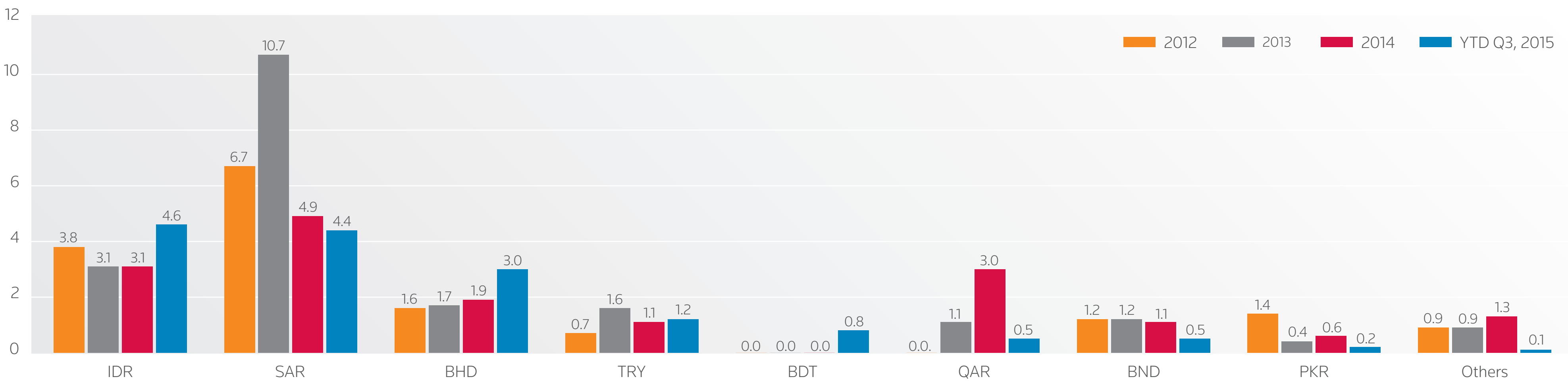
GLOBAL SUKUK ISSUED BREAKDOWN BY CURRENCIES IN Q3 2015



GLOBAL SUKUK HARD CURRENCIES COMPARISON (2012-Q3 2015)



GLOBAL SUKUK HISTROICAL TREND BREAKDOWN BY TOP CURRIENCIES – EX. MYR & USD (2012 - Q3, 2015)



By Risk Classification

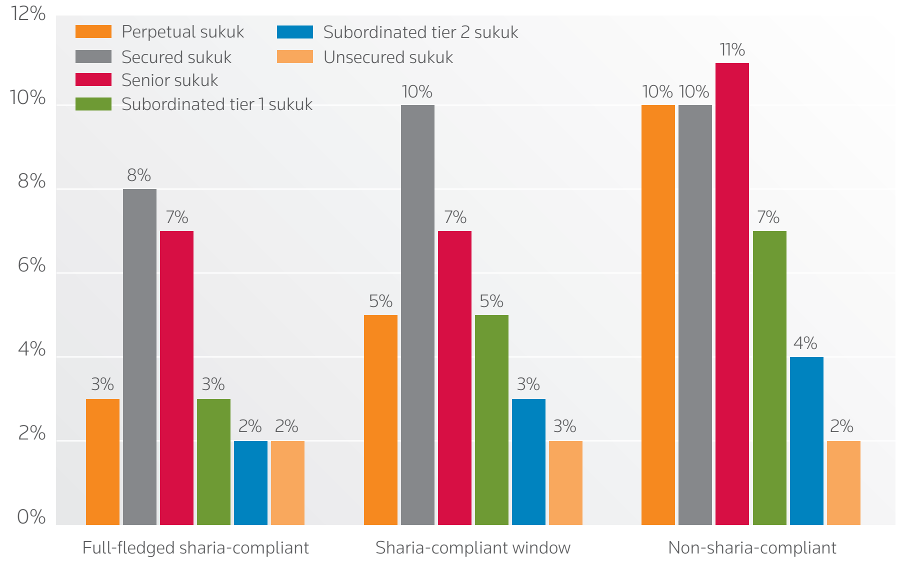
Sukuk players' appetite shifting towards secured sukuk

With the drop in oil prices and expected increase in interest rates, the majority of investors and other key market players prefer secured sukuk issuances followed by senior sukuk.

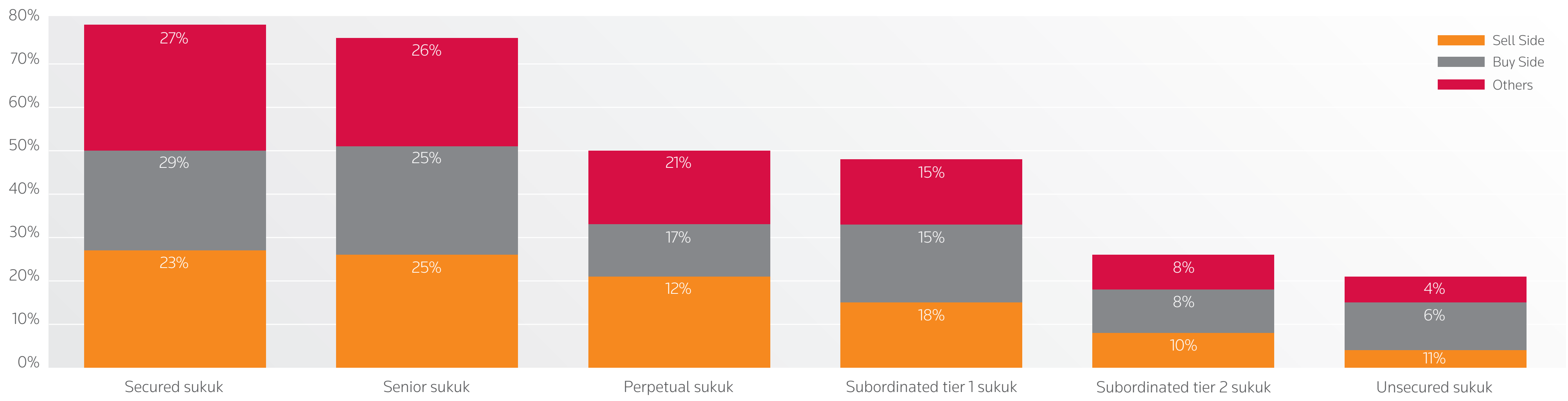
Interestingly despite uncertain market conditions, issuers and lead arrangers still prefer senior sukuk as their second preferred classification. Senior sukuk carry higher risk, so it is interesting that they are the second most perfered in an uncertain market.

Tier 1 sukuk attracts 18% of investors and 15% of issuers, as banks can benefit from sukuk to boost their capital to comply with Basel III requirements.

SURVEY BREAKDOWN – SUKUK CLASSIFICATION BY TYPE OF INVESTOR



SURVEY FINDINGS – SUKUK CLASSIFICATION PREFERENCE



By Rating

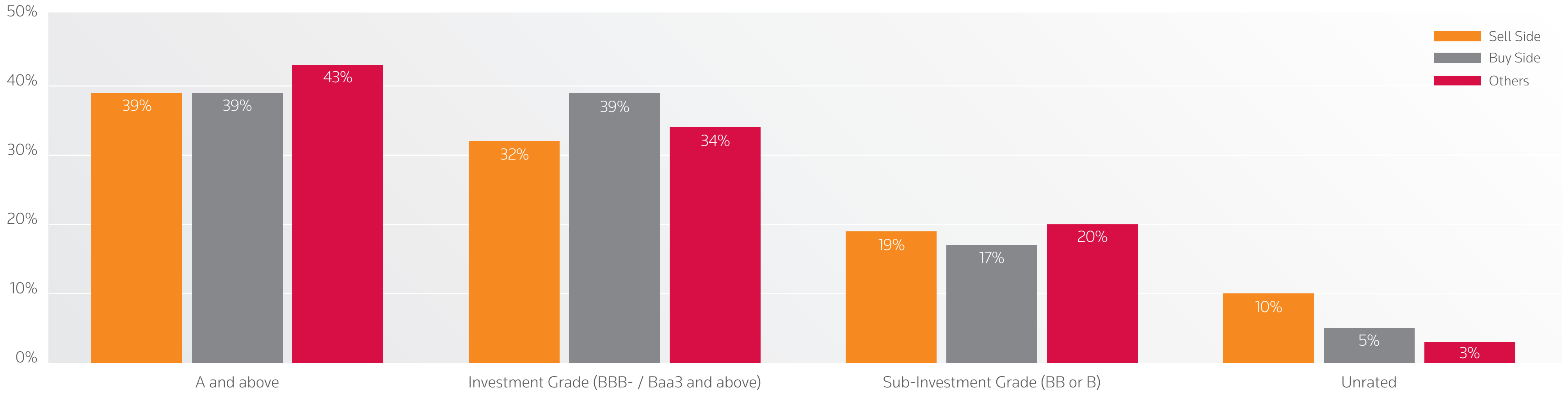
Market conditions push sukuk players to high quality papers

In many ways, rating a sukuk is not significantly different from rating a conventional bond, with the exception of cost and understanding the flows of obligor rights and responsibilities. For markets dominated by domestic sukuk such as Malaysia, sukuk rating may not be as important a consideration as for issuers tapping the global markets. Sukuk ratings provide an indication of the creditworthiness and the probability of default of the issuer. Most Malaysian sukuk are issued in the local currency in domestic markets where issuers are comfortable with capital market conditions and investors are familiar with the different credit risks. Malaysia has released plans to remove credit rating requirements from 2017 to lower transaction costs and attract more issuers. The UAE also released new sukuk and bond rules in September 2014, including exempting corporate bonds and sukuk from ratings, in a bid to lower costs and encourage more issuance.

Market analysts estimate that issuers can be charged about 0.06% of a total sukuk size by rating agencies and the annual review can be an additional 0.05%. However, for unrated sukuk to gain buyers, investors will need to relax their mandates to onboard them into their portfolios. Investors would also need to do their own credit analysis homework either through fund houses or their own investment/ credit departments which may require longer approval periods.

Our Sukuk Survey reveals that high quality investments continue to be preferred over investment grades (BBB-/Baa3 and above) as market players prefer investing in companies with lower risk and adequate returns. Given the undersupply of sukuk in the market, investors are indifferent towards A and above and Investment Grade (BBB- / Baa3 and above) rating, both at 39%.

SURVEY FINDINGS – RATING PREFERENCE



MOODY'S PUTS MORE EMPHASIS ON THE STRUCTURE OF THE SUKUK

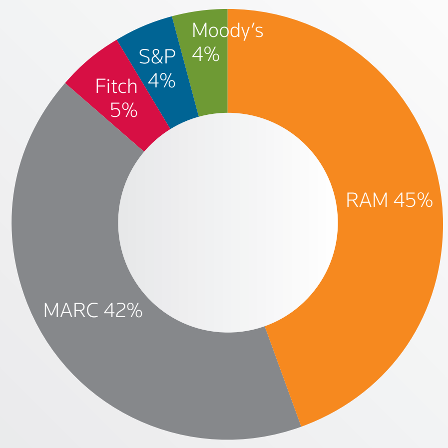
Moody's rating agency looks at different aspects of the issuer when rating a sukuk but it places more emphasis on the structure of the sukuk itself. Moody's sukuk rating process mirrors its process for rating conventional bonds. However, Moody's does not take into consideration the compliance of sukuk with Shariah; the company considers Shariah a matter of expert opinion and not objective fact, and which hence could be open to the possibility of dispute.

The structure of the sukuk -- whether asset-based or asset-backed -- plays a significant role in determining the rating of the sukuk. A number of issuers have issued asset-backed sukuk to get a higher rating (as asset-backed sukuk are more secure), which results in better pricing compared to unsecured sukuk. The rating analysis is different for asset-backed sukuk as these are solely dependent on the assets, while asset-based sukuk would be dependent on the quality of the borrower.

It should be noted that while it is true that most sukuk will have underlying assets, Moody's will consider them to be asset-backed only if the key securitization elements are in place to ensure that sukuk investors have beneficial title though a true sale. However, should the sukuk involve no securitization in its structure, the rating from Moody's will likely be derived by the borrower and the traditional conventional corporate finance analysis would apply.

"In asset-backed sukuk, the rating analysis would be dependent on the assets, while asset-based sukuk would be dependent on the quality of the borrower."

TOP 5 SUKUK RATING AGENCIES



Source: Thomson Reuters Zawya

The Malaysian rating agencies, RAM and MARC, dominate the sukuk rating market -- the two combined make up 87% of all rated sukuk worldwide. It doesn't come as a surprise given Malaysia is the biggest sukuk market, and majority of sukuk issued are domestic. Malaysia traditionally holds more than 65% of total sukuk issues, although this share dropped to about 50% for the first 9 months of 2015.

The three big rating agencies -- Moody's, S&P and Fitch -- are more active in the international sukuk market.

S&P REVISES ITS SUKUK RATING CRITERIA

S&P Ratings Services revised its criteria in January 2015 to rate sukuk at the same level as the sponsor.

Under the new rating criteria, S&P rating services reports the following:

"A credit rating is assigned at the same level as the sponsor's senior unsecured rating, if the next five conditions (A-E) are met:

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

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

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

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

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

Source: S&P Ratings Services

"S&P Ratings Services revised its criteria in January 2015 to rate sukuk at the same level as the sponsor."

By Structures

Wakalah overtakes murabahah in 2014

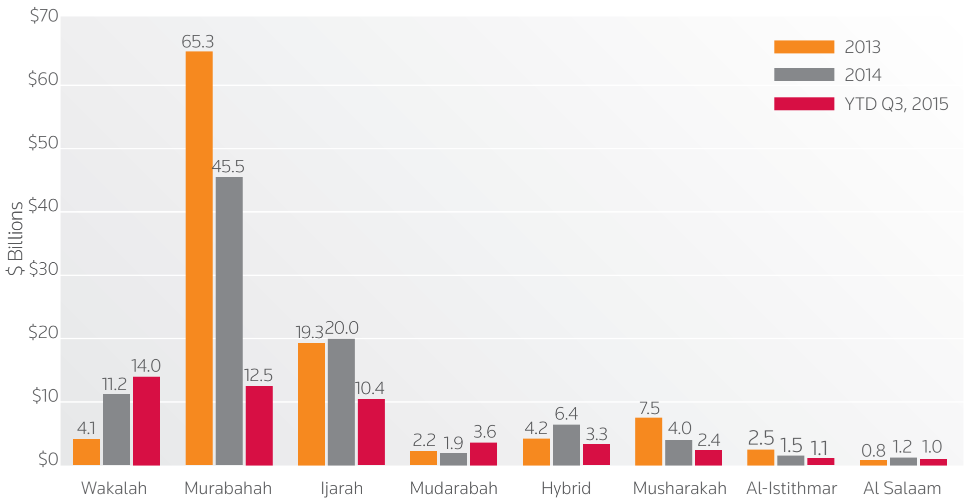
Murabahah sukuk has dominated the market for many years but in 2014 it was overtaken by wakalah, which is a structure now favored by the Malaysian as well as GCC markets for its tradability. Wakalah sukuk is unlike murabahah that cannot be traded as per AAOIFI standards (as it is considered debt). In Malaysia, however, investors can trade murabahah sukuk in the secondary markets.

The total value of 49 wakalah sukuk issued in 2014 equalled $13.979 billion. Of these 49, 11 were issued outside Malaysia: these were 4 in Turkey, 3 in UAE, 2 in Indonesia and 1 in each of Hong Kong and the United States.

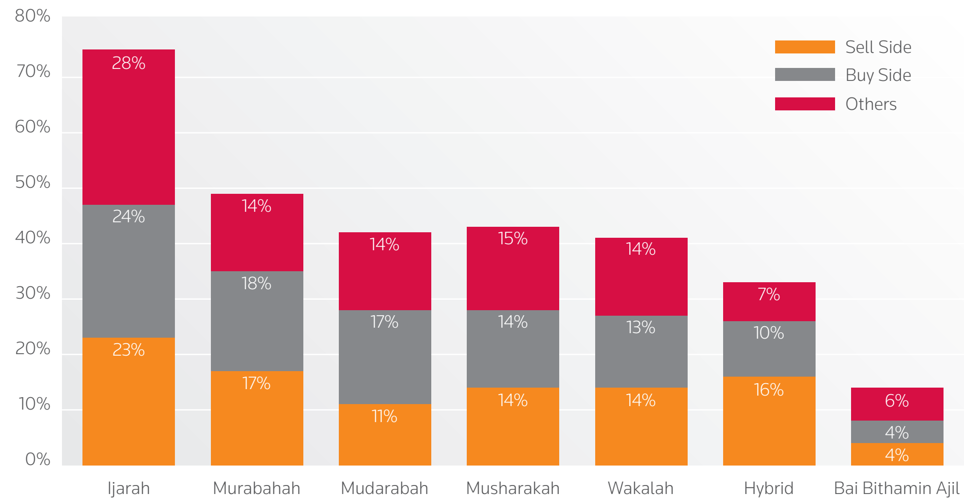
GCC countries continue to prefer the ijarah structure and the consistent use of ijarah has been the trend for nearly a decade. It is expected that the ijarah structure will be used more extensively given its tradability. The use of both ijarah and wakalah will continue to pick up in Malaysia as issuers will take advantange of the tax deductions extended for these 2 structures (tax deductions are for up to 2018 and not extended for murabahah). For now, Malaysia still predominantly prefers issuing murabahah sukuk.

Global Sukuk Issued in 2014 Breakdown by Structure		
Sukuk Structure	Amount Issued ($ Million)	Number of Sukuk
Wakalah	$13,979.16	49
Murabahah	$12,507.42	142
Ijarah	$10,384.73	93
Mudarabah	$3,626.58	56
Musharaka	$2,427.09	38
Modarabah-Murabahah	$2,239.94	5
Al-Istithmar	$1,066.64	1
Al-Wakalah Bel-Istithmar	$1,022.85	2
Al Salaam	$989.37	115
Bai Inah	$502.63	9
Murabahah-Musharakah	$22.85	2

SUKUK STRUCTURE GROWTH COMPARISON (2014 - Q3,2015)



SURVEY FINDINGS – STRUCTURE PREFERENCE

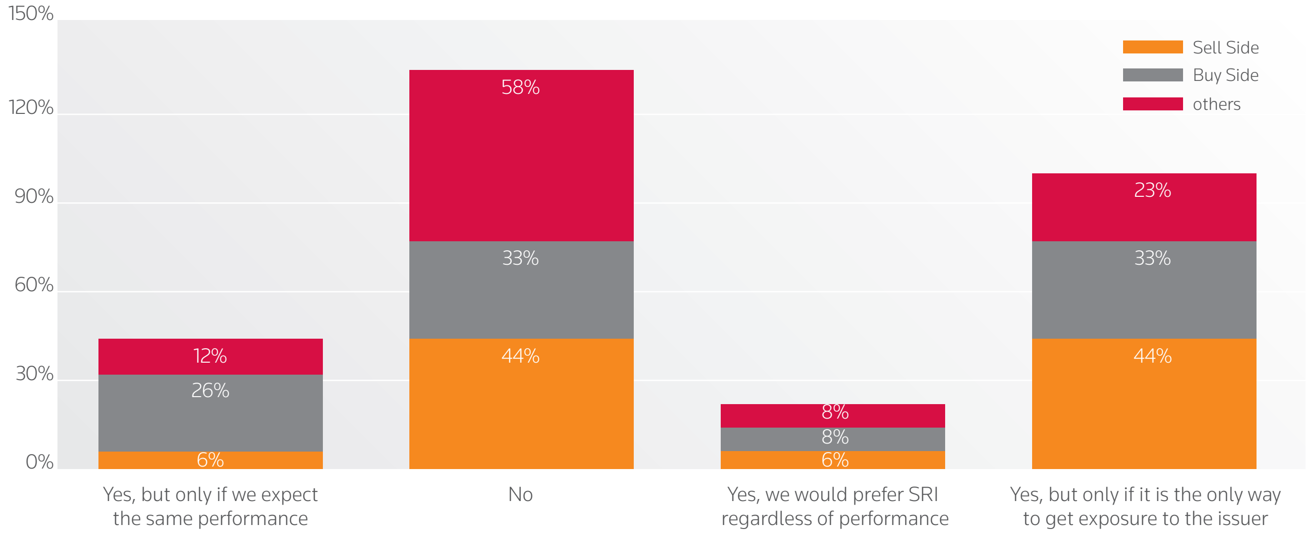


SRI SUKUK RECEIVED A LOT MORE ATTENTION IN 2015

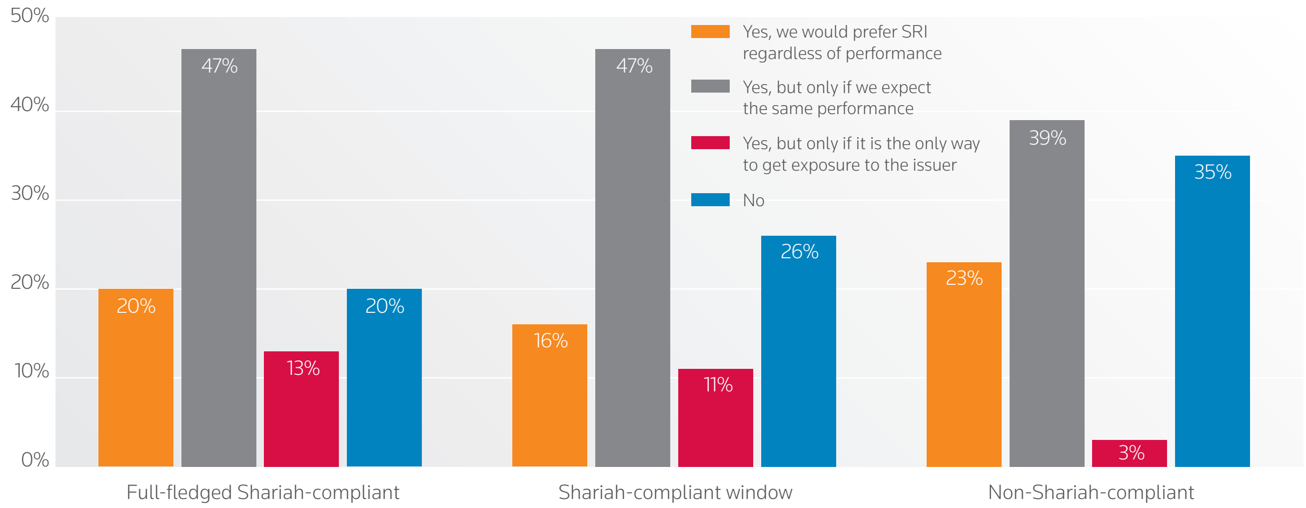
The first SRI sukuk was issued early in 2015, by the Malaysian government's strategic investment fund Khazanah. The structure presented a new method of funding Trust Schools through the private sector via the debt capital markets. Under Khazanah's SRI sukuk programme, proceeds from the first issuance, a 7-year tenor paper, was used to fund the roll-out of 20 Trust Schools under Yayasan AMIR's (YA) Trust Schools Programme for 2015.

The Islamic principle used in this first SRI sukuk is wakalah bi al-istithmar, which further affirms Khazanah's continued effort to push the envelope on innovation. The structure allows the issuer to use a combination of tangible assets and commodities; this is relatively asset efficient and thus suitable for the issuer, SPV, and Khazanah. Another unique feature of this sukuk is that it also allows sukukholders to convert their investment in the sukuk into a donation at any point during the tenure. The sukukholders will be entitled to receive tax vouchers from YA, through Khazanah, for an amount equal to the amount waived or reduction in the nominal value of their respective sukukholdings. The issuer has stated that this is a balance between managing for downside risk and contributing to social good while reducing commercial returns.

SURVEY FINDINGS – DO YOU HAVE A PREFERENCE FOR SRI SUKUK/BONDS OVER TRADITIONAL SUKUK/BONDS?



SURVEY FINDINGS – DO YOU HAVE A PREFERENCE FOR SRI SUKUK/BONDS OVER TRADITIONAL SUKUK/BONDS?



Sukuk is known as a fixed income instrument; however, there have been cases when it can actually be quasi-fixed income such as exchangeable sukuk, or other unique structures such as CoCo sukuk, SRI sukuk or some other type of hybrid sukuk.

EXCHANGEABLE SUKUK

For the sake of clarity, the difference between exchangeable and convertible sukuk is that the former allows investors to get shares in a company other than the issuer while for the latter the sukuk is convertible into the issuer's shares. Exchangeable sukuk first appeared in Malaysia in 2006 through the Malaysian government's investment arm, Khazanah Nasional Berhad. The sukuk from Khazanah involved a structure that was backed by Shariah-compliant assets i.e. equities of Telekom Malaysia Bhd. The periodic sukuk coupon payment was also not guaranteed and had to be paid from the performance of the company, a method which is based on sharing profit and risk.

The shortage of coupon payment is covered through a sinking fund account for the benefit of investors, while the dividends are collected to ensure the availability of funds to meet the payment obligation through the life of the sukuk.

RETAIL SUKUK

Indonesia kickstarted the retail sukuk sector in 2009, capitalizing on its huge Muslim population through a Rp 5,556 million issue from the government. Since then the government has issued one retail sukuk every year, with the latest in 2015. Each issue has been ijarah sukuk with a 3-year maturity. Retail sukuk have also been issued in Malaysia, Pakistan, and Bahrain. They provide an investment avenue for the low- and middle-classes seeking better returns from other than savings accounts and fixed deposits. Increasing financial inclusion and diversifying the investor base are the chief motivations that governments have cited for issuing retail sukuk. They raise funds from a new investor base which remains significantly untapped in most countries and in a country like Indonesia retail sukuk could also be more effective to spread awareness about Islamic finance.

However, one of the downsides of retail sukuk is the shift away from bank deposits, which would lower the growth of Islamic banks or increase their financing-to-deposit ratio, although this is likely to be limited. Apart from diversification of funding for issuers and financial inclusion for investors, retail sukuk provide a more secure investment opportunity when compared to a bank deposit. A bank deposit is an unsecured obligation of a bank, and if the restricted mudarabah structure is applied, the deposit would be even more unsecured given the restrictions involved. In this case, the investors, as the rab ul-mal, would depend on the performance of the borrowers who receive financing from the bank, while remaining at risk to loss of principal. A government retail sukuk removes, or at the worst, limits the risk of loss of the principal amount. However, there may be a loss in value received at maturity which is associated with the devaluation of currency.

COCO SUKUK

Financial institutions are also considering a new structure to hedge against what is described as unfavorable terms for their main shareholders when issuing sukuk from outside investors to boost the FI's capital adequacy ratio (CAR). To hedge against any unfavorable position, banks are considering the use of a hybrid sukuk, also known as Contingent Convertible (CoCo) sukuk. CoCo sukuk is a hybrid security in which sukuk certificates give the investors a contingent right to convert their certificates into equity. CoCos become convertible when the price of the issuer's equity rises above a certain amount. The advantage of a CoCo structure is that it helps banks meet their capital adequacy funding in addition to providing a favorable tax treatment. However, the CoCo structure is still relatively new to the Islamic capital market, which is largely plain vanilla. It will be some years before CoCo sukuk will take root in the Islamic capital market, if at all. There are challenges to overcome before the structure can be widely used. One challenge pertains to the avoidance of uncertainty (gharar) and what structure could ensure the sukuk gharar-free. Other challenges include choosing the underlying assets and identifying the source of cash flow. To date, while CoCo sukuk have been issued by banks to boost their capital adequacy, its mandate has not been introduced under Basel III requirements as it still needs to be more fully scrutinized.

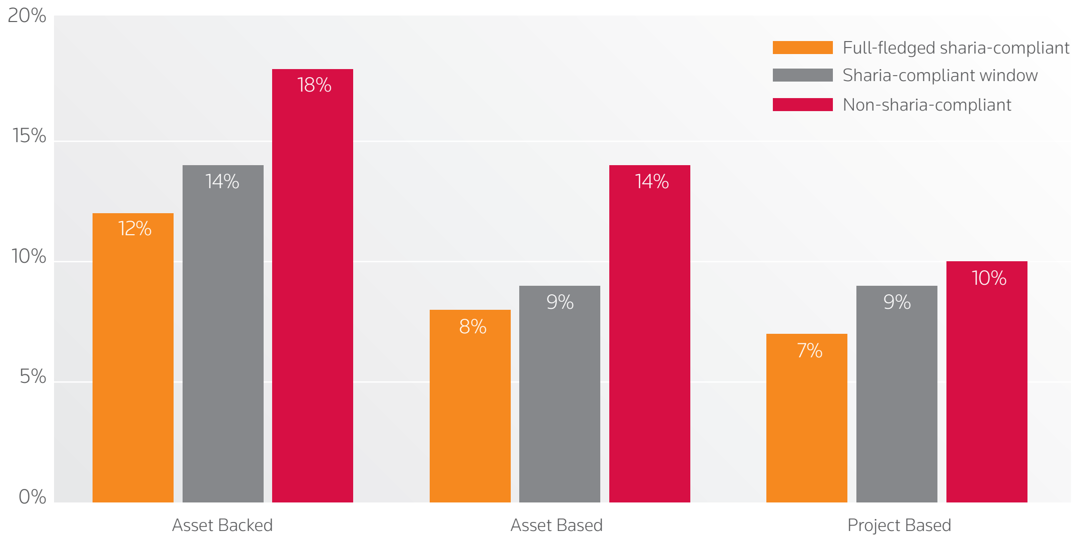
By Risk Classification

Sukuk market appetite shifting towards secured sukuk

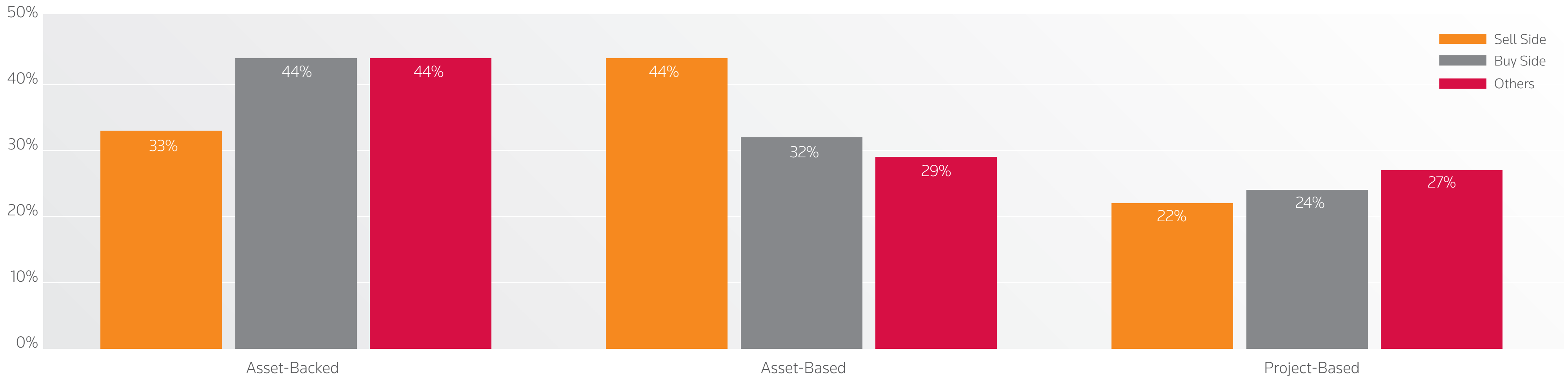
44% of investors and other key market players prefer the lower risk asset-backed structure to protect themselves in case of default.

Another 44% of issuers prefer asset-based structure for their sukuk, as it involves less legal documentation with regards transferring assets to the investors, hence reducing costs. The difference between asset-based and asset-backed sukuk is critical to the epistemology of sukuk itself. Asset-backed sukuk are securitization of mostly tangible assets with ultimate recourse being to the securitized asset while asset-based sukuk are securitization of receivables or usufruct and resource is almost certainly to the credit of the issuing entity (obligor). In most instances, the revenues in asset-backed sukuk are expected to be generated from the underlying asset's revenues, while the revenues in asset-based sukuk are expected to from the obligor's cash flows.

SURVEY BREAKDOWN – RISK CLASSIFICATON PREFERENCE



SURVEY FINDINGS – RISK CLASSIFICATION PREFERENCE



Market Opinion

Infrastructure sukuk

By Blake Goud, Chief Research Officer for ME Global Advisors

BLAKE GOUD

Blake Goud is the Chief Research Officer for ME Global Advisors, gateway connectivity and intelligence platform to opportunities in the rapidly developing MENASEA region and the CEO of the RFI Foundation, a nonprofit organization working to identify a neutral, nonpartisan and universal value proposition for responsible finance.

One of the big areas where sukuk are viewed as providing significant value is in the area of infrastructure financing. Sukuk, the argument goes, are tied closely to 'real assets' in their structure and embed the risk sharing features that are one of the most recognizable of the Islamic finance market overall. However, several key factors could limit the applicability of sukuk in the environment we see for sukuk markets, and particularly if the projects involve public-private partnerships.

One of the biggest limitations for infrastructure sukuk is that in many cases, the projects being financed are for new infrastructure that do not exist today, whether it is football stadiums in Qatar, new hotels in Dubai built in anticipation of the huge influx expected around Expo 2020 or new desalination plants across the region.

The trade-off that exists when arranging financing structures for new assets is between the flexibility for investors to trade and the originator to determine the degree to which they bear the ultimate risk to the projects. In years past, the infrastructure projects have been principally or entirely sovereign undertakings so the issue is irrelevant.

For a project that is being undertaken entirely by the sovereign who will be bearing the risks from it, it is possible to use government-owned land on which the infrastructure is being constructed in a sale-and-leaseback transaction. If the government is providing the bulk of the financing for the project, the value of the land being used should not constrain the amount of financing required for the project. If the value of the underlying land was significantly smaller than the funding needed, the size of the financing could be upsized by using a wakalah structure that bundles together the sale-and-leaseback on the underlying land with financial receivables (like commodity murabahah) to effectively double or triple the size of the financing (depending on whether the Shariah board prefers a 51% or 33% tangible asset threshold for the project).

Apart from these ways to expand the size of the infrastructure sukuk themselves, additional project funding could be had from banks (either conventional, Islamic or a combination of the two). Based on the typical structure used in privately-financed public infrastructure projects, there will be an 'all-of-the-above' approach taken in most cases. This raises two possible concerns:

1) The conventional privately-financed infrastructure projects are heavily leveraged and Islamic finance is conceptually supposed to avoid heavily leveraged projects.

2) The asset-liability mismatch created by large infrastructure projects would strain most Islamic banks' balance sheets and most sukuk investors have shorter time horizons.

The rest of this article will focus on the first point, but the second is equally important given the importance of bank financing (and avoiding refinance risks in infrastructure projects).

'HEAVILY LEVERAGED'

First, it is important to step away from the narrow structuring issues involved with most Islamic finance transactions. Each step to finance an infrastructure project could be replicated with the needed Shariah compliance modification. A $1 billion infrastructure project could have $545 million in equity contributions plus land worth $150 million set aside for a sale-and-leaseback transaction combined with $150 million in commodity murabahah receivables in a sukuk and then raise $155 million in Islamic syndicated bank loans.[1]

The transaction is Shariah-compliant but the end result is a project where the equity is leveraged 83% (the average on energy and water projects globally) and could easily be incorporated into a portfolio of infrastructure projects to amplify the leverage. [2]Furthermore, the project risk has been inequitably shared within the project transaction so that there is a priority given to the sukuk and Islamic syndicated facility that is not commensurate with any outcome from the project itself.

It is also a project which is Shariah-compliant on its face but one which if the Islamic debt finance were replaced by conventional debt in equal levels, would make the equity tranche impermissible. Areas like infrastructure finance are notably leveraged in the conventional side so it is an asset class where the debate about how good a fit the form over substance choice is when the decision revolves solely around using conventional bank loan and bonds or Islamic bank finance and sukuk with an identical economic outcome.

Furthermore, unlike in banks (where much of the form versus substance criticism is focused), there are not equivalent capital requirements and heavy regulatory inertia that presses a finger on the scales in weighing form versus substance. An infrastructure investment fund can take a 'bank' model or it can use a 'fund' structure. If it uses a bank model (as presumably the Asian Infrastructure Investment Bank will), it will have to rely on the conventional analogue products that split risk and reward largely on conventional lines.

However, if it avoids the strictures of the bank model for a fund (or one could say 'shadow bank'), there would be the potential to introduce an alternative set of economics into the picture that more closely resemble project-based equity sukuk. These would have the possibility of remaining in a senior position to equity (by virtue of using an asset-based structure) but would be able to offer potentially higher returns than straight debt if investors bear some of the risk that returns are not as high as anticipated.

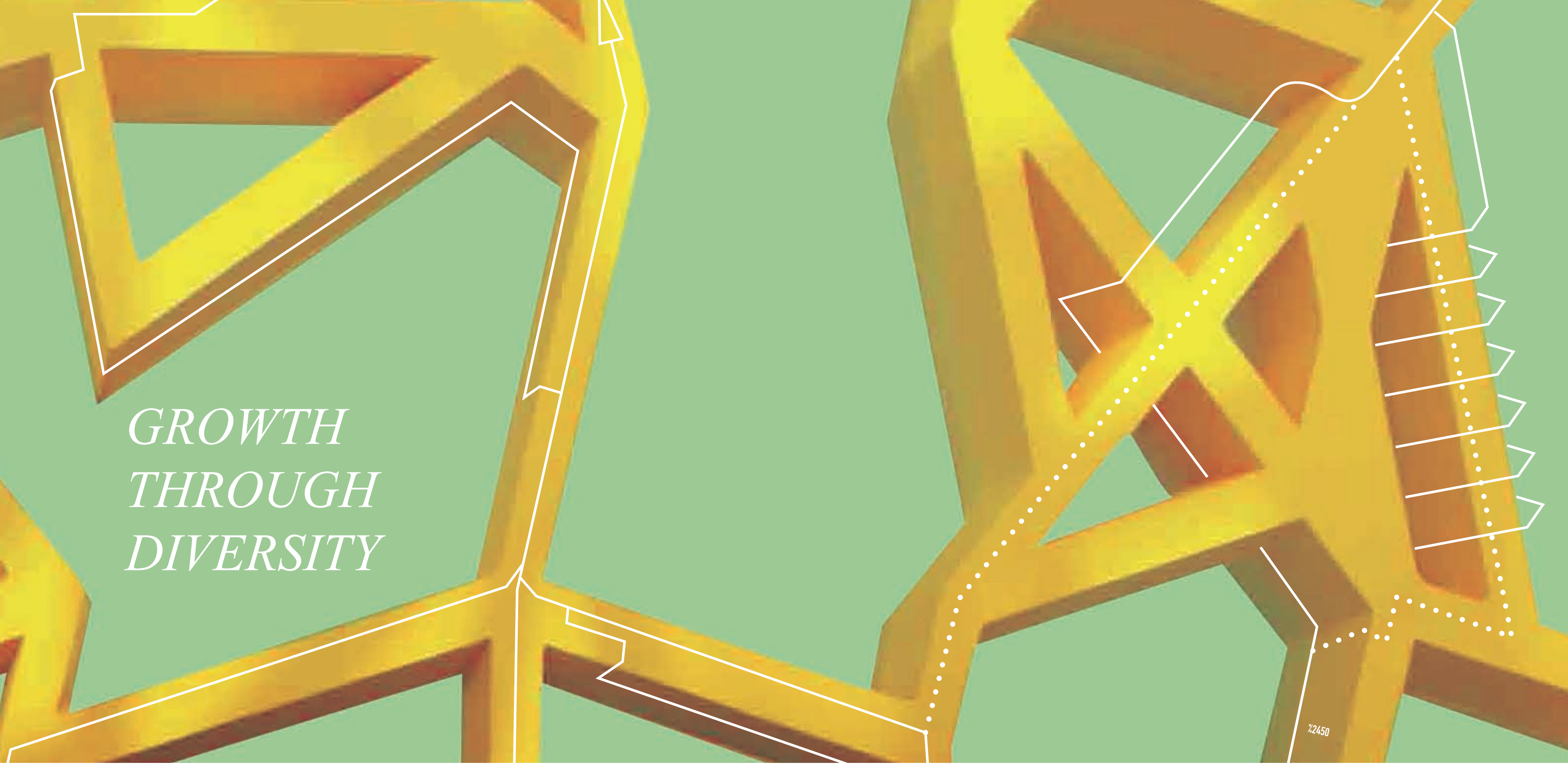
In the Middle East, as elsewhere, there is plenty of project risk to go around and spreading that risk more widely across the investors in infrastructure projects can help increase the equity proportion and reduce the debt proportion (as each would undoubtedly shift based on lower risk to equity from lower leverage and higher risk to sukuk investors from a project-based set-up). The shift in risk allocation makes sense since cost overruns and delays are common. A PwC study in 2014 surveyed both project owners and contractors about the primary reason for delays. As would be expected, the owners put the bulk of the responsibility on contractor or subcontractor performance. [3]But so did the contractors. Some of this is just attempts to avoid responsibility but not all. The same survey found that 35% of contractors blamed the realism of original timescales for the delay—something which even 24% of owners agreed with. [4]This suggests that the expectations are not set appropriately for projects from the outset, the bulk of which will end up affecting equity investors rather than creditors. It seems like a situation calling out for a revision in both the mindset when developing projects and in the financing process where a revision like incorporating the use of project-based equity sukuk can be realized through changing the economics for different players in the finance side that will more appropriately apportion risk and reward.

[1] Bitsch, Florian, Axel Buchner and Christoph Kaserer. 2012. "Risk, Return, and Cash Flow Characteristics of Private Equity Investments in Infrastructure,' Alternative Investment Analyst Review,
[2] Ibid.
[3] PwC. 2014. Beyond Building Ambition: Middle East Capital Projects & Infrastructure Survey, June 2014, p. 16.
[4] Ibid.

DATA PRESENTED IN US$ 2010 RATES

Sector	Business-as-usual scenario investment needs		2°C scenario investment needs		Incremental investment required		Sources
Power generation	6,933	347	10,136	507	3,203	160	IEA
Power transmission and development	5,450	272	5,021	251	(429)	(21)	IEA
Energy total	12,383	619	15,157	758	2,774	139	
Buildings	7,162	358	13,076	654	5,914	296	IEA
Industry	5,100	255	5,800	290	700	35	IEA
Buildings & Industrial total	12,262	613	18,876	944	6,614	331	
Road	8,000	400	8,000	400	-	-	OECD
Rail	5,000	250	5,000	250	-	-	OECD
Airports	2,300	115	2,300	115	-	-	OECD
Ports	800	40	800	40	-	-	OECD
Transport vehicles	16,908	845	20,640	1,032	3,732	187	IEA
Transport total	33,008	1,650	36,740	1,837	3,732	187	
Water	26,400	1,320	26,400	1,320	-	-	OECD
Agriculture	2,500	125	2,500	125	-	-	FAO
Telecommunications	12,000	600	12,000	600	-	-	OECD
Forestry	1,280	64	2,080	104	800	40	UNEP
Other sectors	Unknown	Unknown	Unknown	Unknown	Unknown	Unknown	
Total investment	99,833	4,991	113,753	5,688	13,920	697	
	~$100tr	~S5 tr	~$114 tr	~$5.7tr	~$14 tr	~$0.7tr	

Source: World Economic Forum



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Chapter Three

Sukuk Year of Transition

REUTERS/Carlos Barria

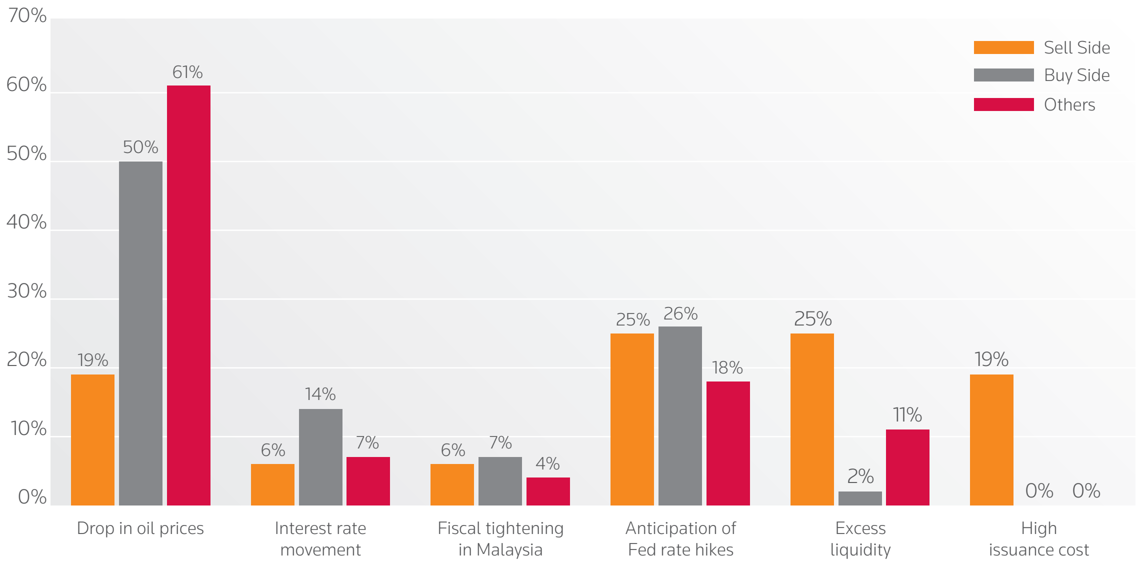
By factors affecting the sukuk market

Market players attribute the plunge in sukuk issuances to the drop in oil prices

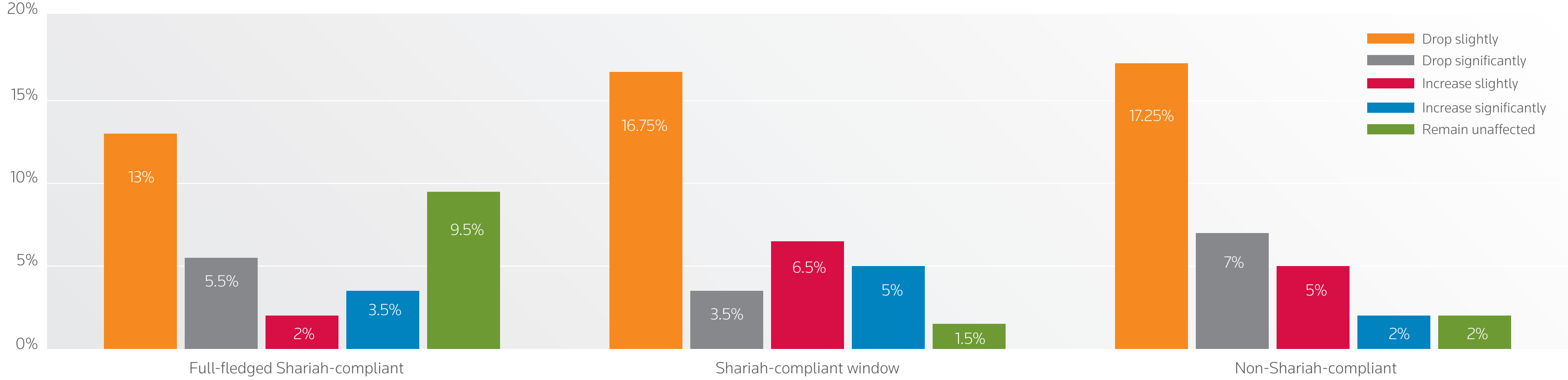
Growth of the sukuk market must be measured by the participation of new markets and sectors and not merely by sukuk volume as new issuers from new sectors show acceptability of sukuk. By this measure (new markets and sectors), the sukuk market experienced a stunted growth in 2015 as there was only 1 new issuer – the Omani government.

As a result a general question was put forward to our Sukuk Survey participants about the overall sukuk drop in 2015. 50% of investors and 61% of other key market players attribute the drop in sukuk issuance to the plunge in oil prices.On the supply side, 50% of issuers believe that the drop in sukuk issuance is due to excess liquidity sitting with issuers, and 25% of survey participants anticipate a hike in the Fed's interest rates.

SURVEY FINDINGS – IN Q1 2015, SUKUK ISSUANCE HAS DROPPED TO US$ 18.3 BILLION FROM US$ 23.1 BILLION SAME PERIOD IN 2014, IN YOUR OPINION, WHAT IS THE MAIN REASON FOR THIS DROP?



SURVEY BREAKDOWN



Malaysia Sukuk Market

By Outlook

Malaysian economy going through the "almost perfect storm"

Malaysia issued less sukuk in 2015 mainly due to Bank Negara Malaysia's decision to stop offering short-term sukuk. The underlying reasons for this decision was: 1. To improve the liquidity of local institutions, by shifting to different instruments, 2. Ripples felt by Malaysian markets (that have hit the Malaysian ringgit) from the volatility in the region especially following the crash in the Chinese stock market. China is Malaysia's main trading partner and the drop in the Malaysian ringgit has had a negative impact on the economy.

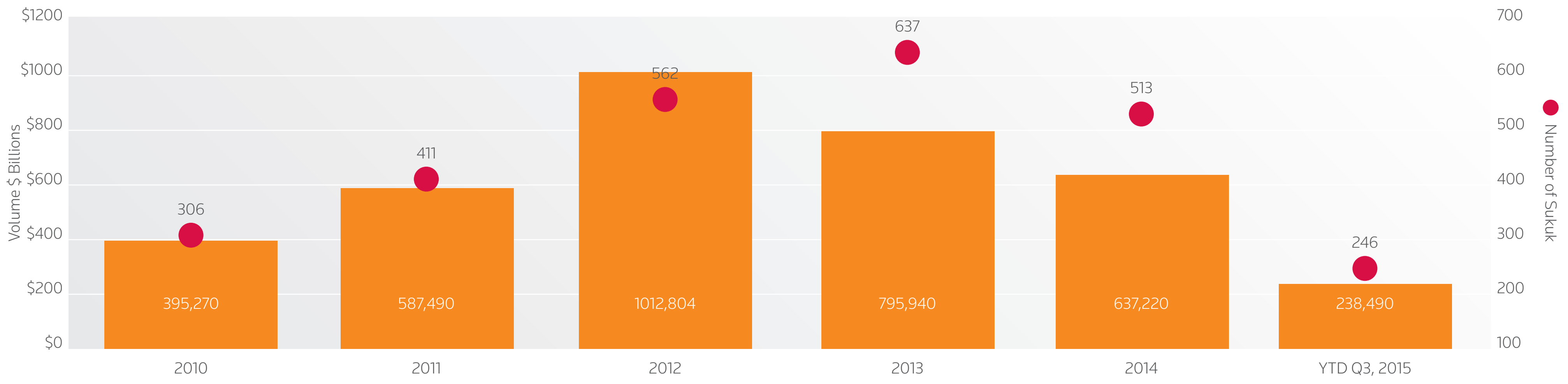
However, the government has said more than once that it has no intention to go back to pegging the ringgit to the dollar as most local companies' debts are in Malaysian ringgit. The companies exposed to the dollar have foreign assets and/or revenue streams in dollars.

Malaysia is a net importer of oil and the drop in oil prices has meant that the country buys cheaper oil, which places less pressure on government expenditures.

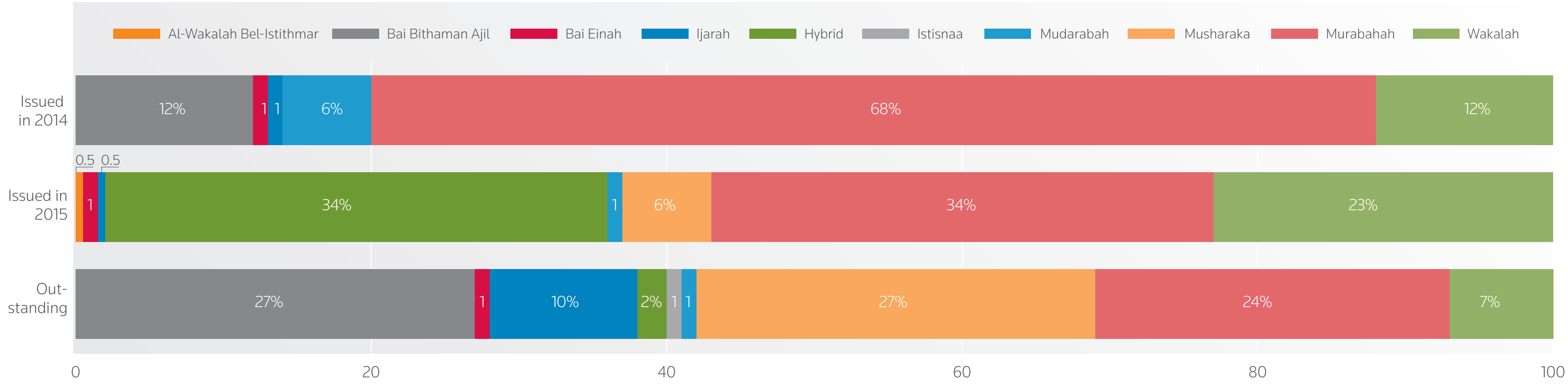
Market players see the 1990s Asian financial crisis repeating itself; however, the Malaysian government believes the country's fundamentals are stronger now than before and the market will be able to overcome the challenges, but recovery maybe slow and sukuk issuance may not pick up in the near future.

"...but recovery maybe slow and sukuk issuance may not pick in the near future."

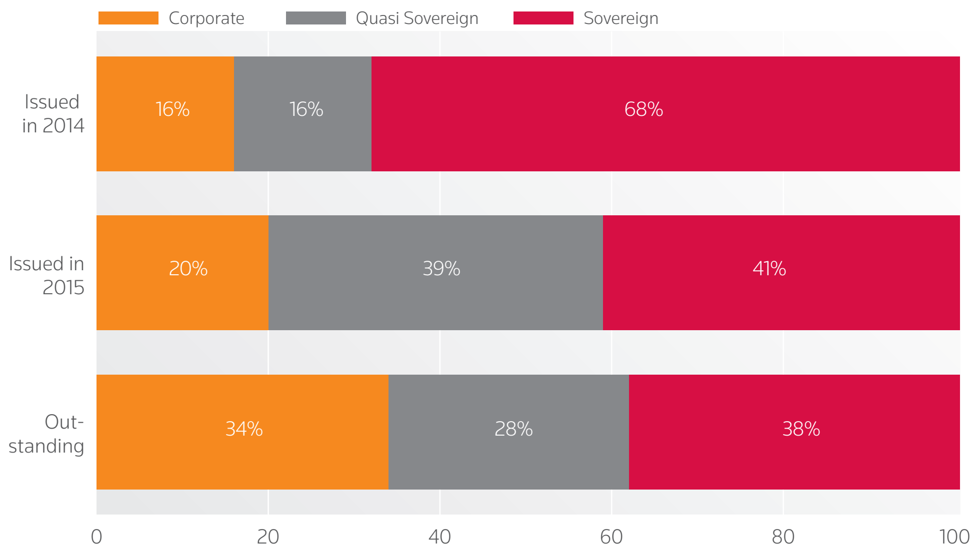
MALAYSIAN SUKUK HISTORICAL ISSUANCE TREND



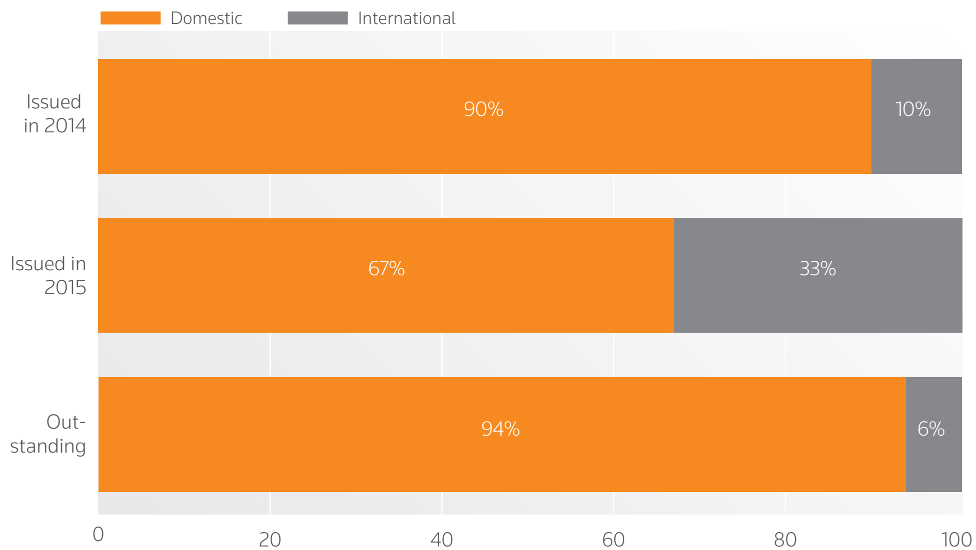
MALAYSIAN SUKUK BY STRUCTURE (Q3 2015)



MALAYSIAN SUKUK BY ISSUER (Q3 2015)



MALAYSIAN SUKUK BY MARKET TYPE (Q3 2015)



Market Opinion

The implications of Bank Negara Malaysia (BNM) cutting short-term sukuk

By Farrukh Raza, Managing Director – IFAAS

Farrukh Raza is the Managing Director at IFAAS (Islamic Finance Advisory & Assurances Services). He holds over a decade of experience in the Islamic finance industry. He has been involved with pioneering grass root-level initiatives to very high-profile projects. These include advising key stakeholders and regulatory authorities on developing the infrastructure for implementing Islamic finance, including frameworks, strategies and capacity-building in several jurisdictions. He has been involved in launching over 100 Islamic financial products for institutional clients worldwide and has also led many market research projects and feasibility studies to launch new Islamic finance operations. Farrukh has also played senior roles at the Islamic Bank of Britain and the first takaful company in Europe.

He holds an MBA in Strategic Management, is a Member of the Chartered Institute of Marketing (UK) and an Associate of Chartered Institute of Securities & Investments (UK). He is also a member of the Commission for Islamic Finance, Paris Europlace (France) and Mosaic Network of Prince's Trust (UK).

The Malaysian sukuk market has dropped significantly this year. What are the underlying reasons? And why?

In my view, the drop in Malaysian sukuk market is a reflection of the turmoil that the Malaysian economy is currently going through, an "almost perfect storm", as a Malaysian government minister has put it. The economic slowdown in China, Malaysia's largest trading partner, near-record low oil prices and the continuing political crisis in the country have led to the most significant erosion of the Ringgit's value since the 1997 financial crisis. The accumulation of these factors is enough to put a dent in the confidence levels in any market making it bearish but in Malaysia's case, the problem seems to be bigger than usual. The high level of interest that the Malaysian sukuk market has historically had from the Gulf investors is diminishing fast as the GCC plunges into oil price crisis and worsening political environment in the region. All these factors have contributed to the Malaysian sukuk market slowdown in 2015 and unfortunately, the current signs are not looking that positive for the near future. However, I believe that the Malaysian market will come out of this storm although it may not be able to sustain its pre-crisis share in the sukuk market as many of the traditional sukuk investors are likely to become issuers due to the increasing challenges they face in deepening crises.

Has Bank Negara Malaysia (BNM) improved the liquidity position in the market by cutting the short-term issuance as per its plans?

What are the implications? It is too early to say whether the liquidity position in the market has improved or otherwise. The BNM short-term sukuk were primarily intended to facilitate the liquidity management of the domestic Islamic banking players however, the majority of these sukuk were being subscribed by the foreign investors. Hence it is very much arguable what real effect they had on the domestic financial market in the first place. While this move has immunized BNM from any potential liquidity problems of foreign players, it can possibly create issues in the long term for Malaysian Islamic banks who may face difficulty in complying with Basel III requirement of holding HQLAs (High Quality Liquid Assets) in the absence of BNM short-term sukuk or an equivalent instrument.

Have the flows changed in the secondary markets, since the BNM cut back short-term sukuk issuances?

The halt on BNM short-term sukuk issuance has reduced Malaysia's debt exposure to foreign outflows that are becoming increasingly probable due to the deteriorating market conditions. The continuously low oil prices have put downward economic pressure on the Gulf countries and many of them are facing budget deficits. Historically, the GCC governments tend to use their reserves to address a deficit situation instead of using debt tools however the current climate has pushed the sovereigns to consider alternatives.

What is the reaction of other Islamic Banks around the world and mainly in the GCC, since they had been placing a large amount of funds in these short-term sukuk? What are the alternatives for these banks?

Shift to equities? One of the major problems with the Islamic financial industry is its stagnation in innovation and the general tendency of sticking to the comfort zone. It is widely understood that Islamic banks are in dire need of liquidity management tools and a more diversified range of investment opportunities. Unfortunately, little has been practically done to address this fundamental issue despite the everlasting debate in the industry. The GCC and other non-Malaysian Islamic banks need to put pressure on their home sovereigns to resolve the matter by increasing supply instead of using BNM's domestic oriented instruments for their liquidity purposes. The stakeholders of Islamic finance industry have to stop looking for short term quick-fixes and instead focus and invest in long term solutions that facilitate the true growth of the industry and provide it with the required sustainability. Shifting to equities is not really an option for Islamic banks as that will create a whole plethora of other challenges. They need to lobby to their governments and push their respective central banks to issue their own instruments. The industry players also need to develop a long term vision and strategy to achieve the objectives instead of taking refuge in temporary solutions.

International investors will be attracted to other countries for liquidity. Which countries will benefit the most from this? Will the sukuk market see a fundamental change in terms of cash flow?

Given the current political and economic climates, it is very unlikely that any of the Islamic countries will be able to take a clear lead in the market. The opportunities are almost equal for everybody but we need to see which of the countries are capable of acting fast and translating the opportunity into tangible benefit. If the GCC sovereigns manage to mobilize their resources in accordance with the need of time, we may be witnessing a shift in the market towards the Gulf however, the complexities of the region and its politics may prevent it from happening. In this case, the probability of a number of non-Islamic countries emerging as sizeable players is quite high. Indonesia can be a potential beneficiary of this situation however it has a number of issues to address as well.

What is the outlook for the sukuk market in Malaysia given the dependence on Malaysian investors, and will it be able to hold its position as the biggest sukuk market globally?

How long will the short-term liquidity last before drying up? The Malaysian sukuk market is capable of recovering from the current slowdown however it may have to adapt itself to the new dynamics by offering something that is more adequate to the future market conditions. It is likely to maintain its leadership role for some time at least however it may not be able to uphold its share in the market at the same level; that is expected to dilute with the new issuers entering in the market or existing issuers increasing their supplies. The short term liquidity will depend very much on how quickly the "almost perfect storm" is over.

How has the volatile Ringgit impacted Malaysia's sukuk market and how do you see the rest of the year playing out?

The Ringgit volatility has had an adverse effect on the Malaysian sukuk market however it may be argued that it is more to do with the negative perception created by the currency's depreciation rather than being actual underlying reasons for such impact. Historically, the Ringgit has shown rebounds within 6 months of a crisis however as of today, there seem to be no signs that it will recover by the end of the year as the drivers of the volatility remain in place.

REUTERS/Edgar Su

"I believe that the Malaysian market will come out of this storm although it may not be able to sustain its pre-crisis share in the sukuk market..."

Market Opinion

Malaysian Sukuk from a Rating Agency perspective

By Khalid Howldar, Global Head – Islamic Finance GCC Financial Institutions

The Malaysian Sukuk market has dropped significantly this year. What are the underlying reasons? And why?

Malaysia is engaged in a fiscal consolidation program, trying to rein in public spending which in turn means less borrowing. This is the key driver for the drop in volumes.

Has Bank Negara Malaysia (BNM) improved the liquidity position in the market by cutting the short-term issuance as per its plans? What are the implications?

The liquidity position of the banks is reasonably unaffected by the reduction in BNM issuance. As mentioned, BNM issuance is meant to remove excess liquidity from the market. The reduction in BNM issuance reflects moderating excess liquidity in the banking system.

Islamic banking system liquidity has tightened slightly driven mainly by the implementation of the Islamic Financial Services Act beginning July 2015, which led to a reduction in investment account deposits of institutional depositors. On the other hand, the growth of retail and corporate business deposits (forming the bulk of Islamic deposits) remain robust.

According to central bank statistics, the Islamic banking system's LCR was 102% at end-August 2015, higher than the regulatory requirement of 70% by January 2016 (which would be increased by 10% per annum to 100% by January 2019). Islamic banks have been managing their compliance with the LCR rule through improving their deposit mix.

What is the outlook for the sukuk market in Malaysia given the dependence on Malaysian investors, and will it be able to hold its position as the biggest sukuk market globally? How long will the short-term liquidity last before drying up?

The Malaysian market is the largest and deepest across many sectors. While the Gulf collectively will catch up in terms of volumes only Saudi Arabia has the long term potential to build a domestic sukuk market as deep as Malaysia's.

As we have highlighted above, the decline in sovereign issuance this year led to the sharp decline in sukuk issuance in Malaysia. Demand for such instruments continues to be strong and supported by the large base of institutional investors.

How has the volatile Ringgit impacted Malaysia's sukuk market and how do you see the rest of the year playing out?

The currency fall has limited effect on the domestic sukuk but will make foreign currency issuances (USD) much more expensive for local issuers, hence discouraging such sukuk issuance.

KHALID HOWLDAR

Khalid Howladar is the Global Head of Moody's Islamic Finance Group and also leads the GCC Banking team in Dubai. He is a leading figure in the fields of sukuk finance and Islamic banking as well as in conventional GCC credit and securitization markets.

Currently based in the Dubai International Financial Centre, he joined Moody's in London in 2001 and was initially an analyst responsible for rating cash, synthetic, high yield, structured and project finance CDOs.

Subsequently he took lead roles in the MENA Business Development team with responsibility for new markets and client outreach before taking leadership of the Dubai-based banking team in 2010.

"...the decline in sovereign issuance this year led to the sharp decline in sukuk issuance in Malaysia. Demand for such instruments continues to be strong and supported by the large base of institutional investors."


REUTERS/Kai Pfaffenbach

Oil Price Impact on Sukuk

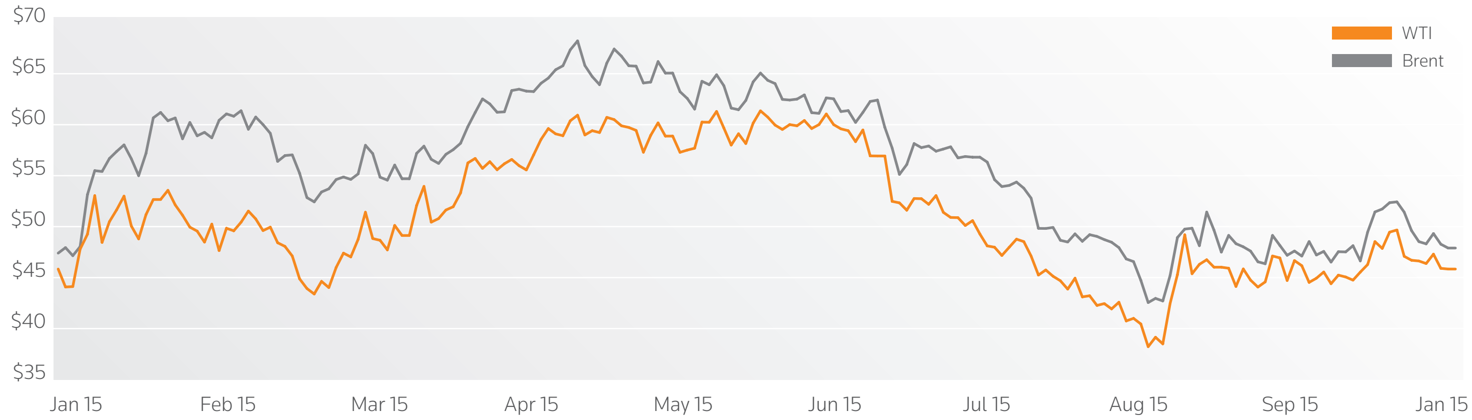
Oil Price Plunges

Market players stress that oil prices have affected the sukuk market

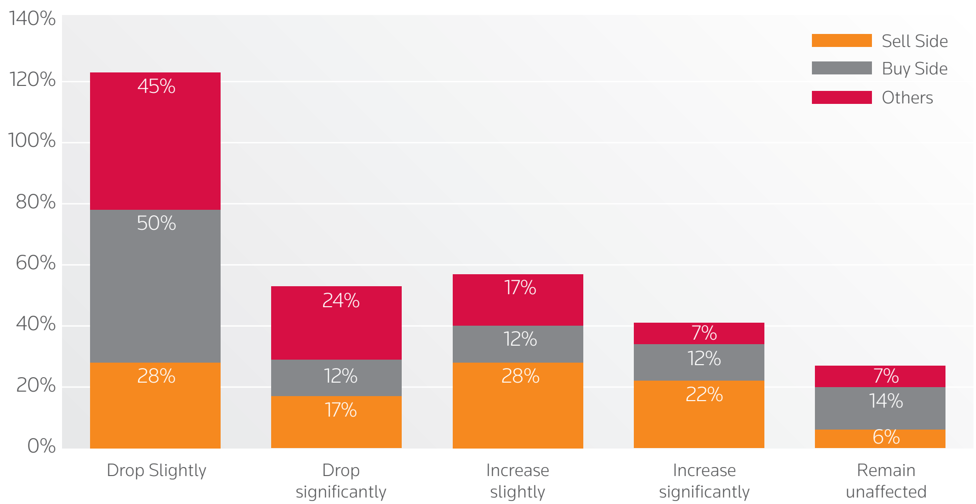
The majority of investors and other key market players are certain that sukuk performance will drop slightly with the drop in oil prices.

Issuers and lead arrangers are split between the sukuk market dropping slightly and increasing slightly (28% each way). The way forward for most sukuk market players may not be clear but sukuk can be an option to raise funds to cover the budget deficits of oil-exporting countries.

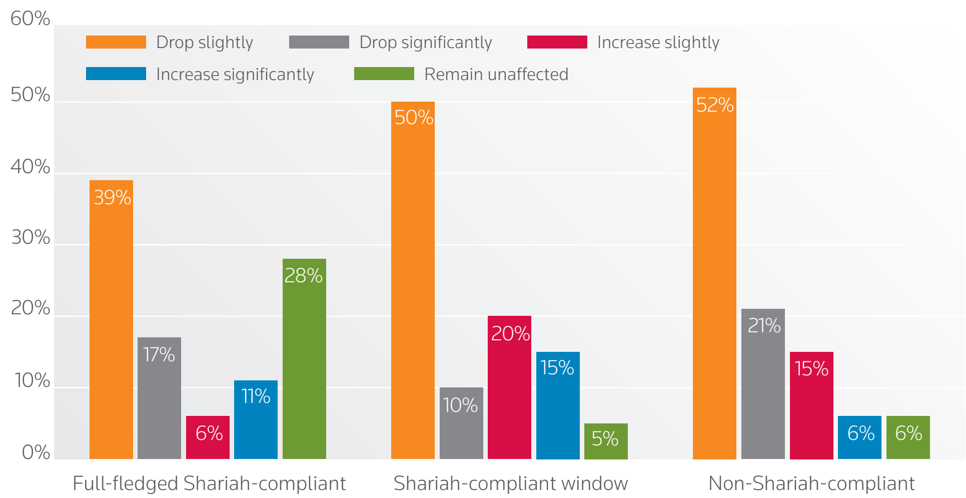
OIL PRICE MOVEMENT 2015 – USD PER BARREL



SURVEY FINDINGS – WITH THE DROP IN OIL PRICES, DO YOU THINK SUKUK PERFORMANCE WILL



SURVEY BREAKDOWN



Market Opinion

The oil prices and its impact on sukuk market

By Mohieddine Kronfol, Chief Investment Officer – Franklin Templeton

MOHIEDDINE KRONFOL

Mohieddine (Dino) Kronfol is a chief investment officer of Global Sukuk and MENA fixed income at Franklin Templeton Investments. He is one of the founding partners and board member of Franklin Templeton Investments (ME), formerly Algebra Capital, and has been with the firm since its inception in 2006. Mr. Kronfol is responsible for the investment process, research and performance of the Global Sukuk and MENA Fixed Income teams. In addition, he manages two funds: the Franklin Templeton GCC Bond Fund and the Franklin Templeton Global Sukuk Fund. He is also a member of Franklin Templeton's Fixed Income Policy Committee Research and Local Asset Management teams.

Mr. Kronfol was previously the Head of SHUAA Capital's Debt Asset Management where he launched and managed the first funds to focus exclusively on MENA debt. Prior to that, Mr. Kronfol was the Head of Capital Markets at SHUAA where he managed investments in global FX, commodity, interest rate and equity markets. Earlier, Mr. Kronfol was a senior associate responsible for fixed income at MECG, one of the MENA region's first pan Arab investment banks.

Mr. Kronfol holds a bachelor's degree in business administration and an MBA. from the American University of Beirut.

What is your outlook for the sukuk market in 2016?

Global markets continue to be well-positioned in the context of the global fixed income market, supported by an environment where growth is moderate, with multiple sources of risk and abundant liquidity. Global sukuk markets continue to benefit from a strong and stable demand base, a steady stream of new issuers, and an exciting growth and development story that supports increasing diversification and potentially competitive risk-adjusted financial performance. Over time, global sukuk could have risk and return characteristics that are unique to the asset class; able to perform throughout all phases of the business cycle.

For 2016, we tend to agree with the consensus view that global sukuk issuance volume will be significantly below the last few years' US$100 billion mark, perhaps up to 40% below, with the amount of global, investable sukuk closer to the US$30 billion mark. This will partly reflect the decision by Bank Negara to halt the issuance of short term domestic issues through public markets, as well as the difficult environment for emerging market and risk assets that may persist. Where we differ from consensus is the importance we place on issuance numbers.

We view issuance volumes as one of many metrics with which to gauge the health of the sukuk market, which in our view remains extremely constructive. 2015 was a very good year in terms of the quality and diversity of issuance. We saw Malaysia and Indonesia delivering on ambitious external sukuk issuance, the first USD-denominated corporate issuer out of Indonesia from Garuda, the Hong Kong government issuing its second sovereign sukuk under a different format to pave the way for local corporates to follow suit, and the GCC issuance pipeline bringing innovative structures and a variety of credits, such as the Emirates Airlines Sukuk backed by the UK export credit agency.

> *"Where we differ from consensus is the importance we place on issuance numbers."*

How much more sukuk activity will we see from oil-exporting countries seeking to bridge their funding gaps, as a result of the drop in oil prices?

We think we should see an increase in issuance from sukuk issuing sovereigns as well as banks looking to shore up capital and address slower deposit growth. GCC governments have reacted to growing budget deficits with a mix of reserve drawdowns, subsidy cuts and reform, spending plan revisions and a more active stance with respect to bond and sukuk issuance.

Saudi authorities, for example, tapped the domestic debt market in June 2015, their first issuance in 8 years, and announced in October of the same year a SAR 20 billion sukuk, which should significantly advance the pace of local and external sukuk market development. Collective GCC budget deficits in excess of US$ 100 billion will improve the outlook for issuance in 2016, and, in our view, trigger increased interest from local and regional investors that continue to harbor strong preferences for equity and real estate investments, often at the expense of their portfolios' risk budgets.

How much has investor appetite for Middle East debt been impacted by the drop in oil price?

We would expect headwinds from lower oil prices, namely subsidy cuts, reduced spending and potential taxation, to work for the benefit of regional debt markets.

Have the flows changed in the secondary, regional and global markets,

since the drop in oil prices almost two years ago?

The sukuk market and related trading activity have been on an improving trajectory, supported by larger issues and a wider acceptance of sukuk into the mainstream. Global fixed income markets, however, are increasingly moving out of the traditional broker dealer banking community, and into institutional investors, mutual funds and "shadow banking" participants, increasing the potential for systemic tail events or risks in the process.

We do not think the risk is acute at the moment nor specific to sukuk, but we do spend time thinking about potential mitigating factors and valuations.

Will the cost of funding increase especially in oil exporting countries given the increase in budget deficit and shortage in liquidity in addition to the expected increase in the interest rates? How can these countries overcome these challenges?

We see the potential increase in benchmark rates having the highest impact on the cost of funding given the currency pegs in place across the GCC. We would not describe the current situation as a shortage of liquidity in GCC banking systems even as we acknowledge that liquidity formation is significantly slower than the previous 5 years. The region remains liquid and governments will be able to tap this liquidity through domestic issuance. We must not forget that governments can continue to draw on accumulated reserves to stimulate growth. With weighted average debt to GDP at less than 10% and accumulated reserves more than double GDP, forecast growth should be well above most developed markets and GCC bonds and sukuk should continue to outperform most other fixed income sectors.

"We do not think the risk is acute at the moment nor specific to sukuk, but we do spend time thinking about potential mitigating factors and valuations."

	2015 Budget Deficit as % of GDP	2016 Budget Deficit as % of GDP	2015 Budget Deficit (USD mn)	2016 Budget Deficit (USD mn)
Bahrain	-12.8%	-11.1%	(4,108.2)	(3,784.3)
Kuwait	-4.2%	1.8%	(5,415.6)	2,579.5
Oman	-12.1%	-10.7%	(8,735.2)	(7,755.0)
Qatar	0.9%	-1.0%	1,598.3	(1,835.3)
Saudi Arabia	-18.6%	-11.4%	(124,845.2)	(84,691.4)
UAE	-4.2%	-2.8%	(15,561.2)	(11,158.8)

Source: EIU

Interest Rate Movement

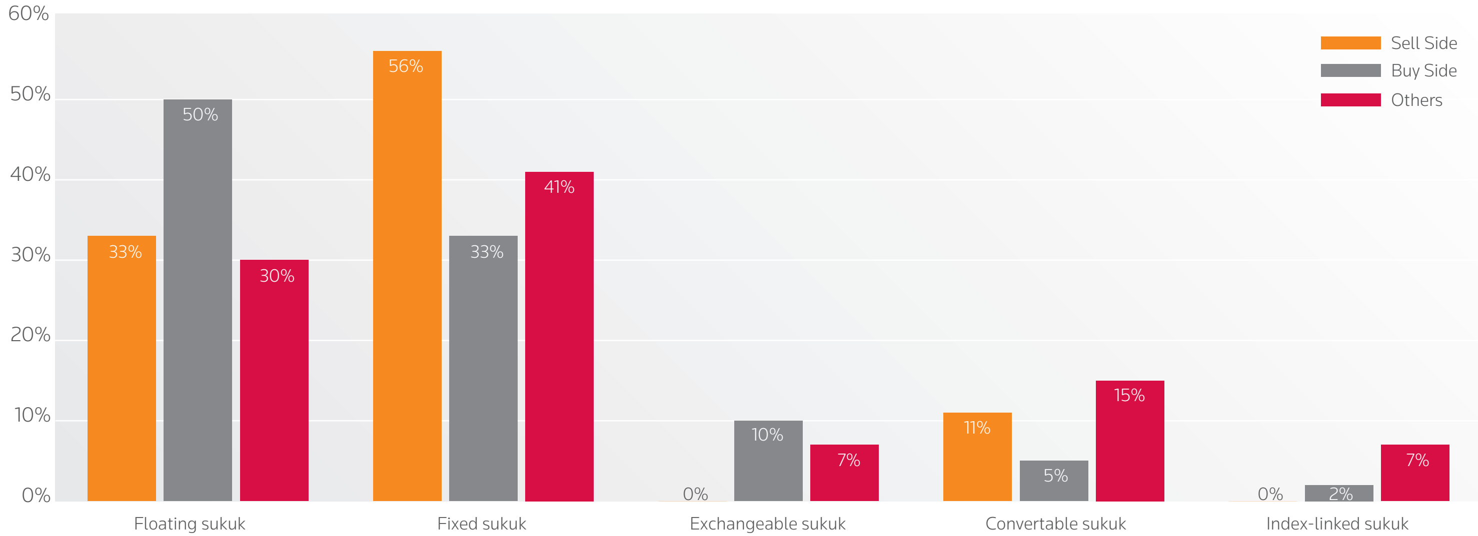
By type of sukuk coupon payment

Market players stand between floating and fixed sukuk to hedge against the expected rise in interest rates

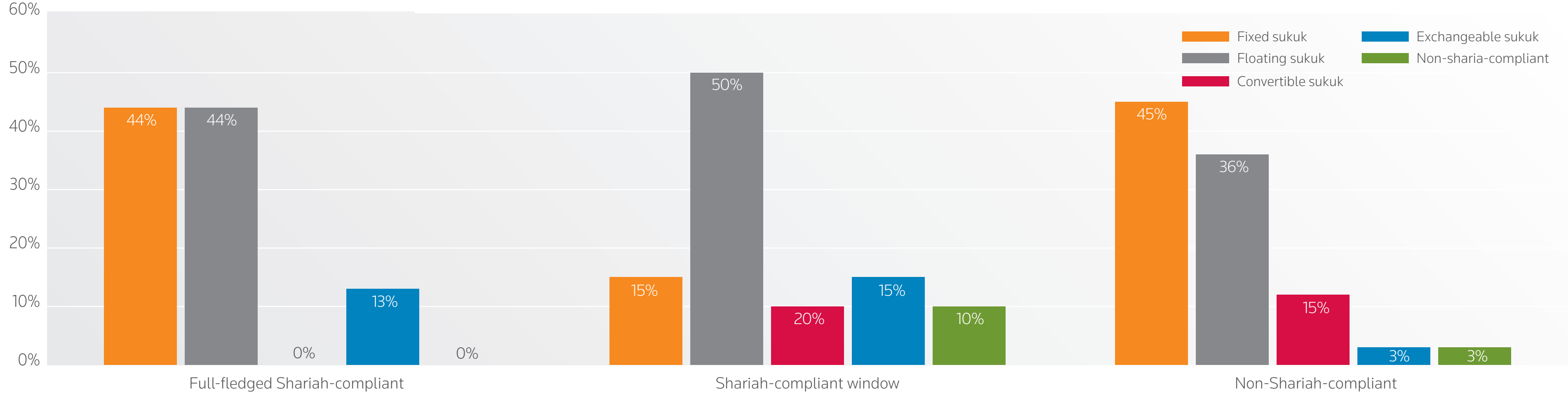
Half of the investors we surveyed would prefer floating sukuk to hedge against the anticipated increase in global interest rates.

On the other hand, 56% of issuers would prefer sticking to the current interest rates and issue fixed sukuk, to avoid paying more should interest rates increase. Other sukuk structures – convertible, exchangeable and index-linked -- do not interest issuers and investors as much in this uncertain market.

SURVEY FINDINGS – WITH A LOW INTEREST RATE ENVIRONMENT, WHAT TYPE OF SUKUK STRUCTURE WOULD YOU PREFER



SURVEY BREAKDOWN



Market Opinion

The expected increase in interest rate has been limited so far

By Giuseppe Ruggiero, Head of Debt Capital Markets – First Gulf Bank

GIUSEPPE RUGGIERO

Giuseppe Ruggiero joined FGB in January 2015 from NBAD, as Head of Debt Capital Markets. Prior to that he was with Goldman Sachs in London where he spent 5 years, focusing on DCM origination/ syndication as well as derivatives marketing for a large portfolio of clients, including high profile CEMEA sovereign and corporate issuers. Giuseppe also spent 3 years at the Italian Ministry of the Treasury, being responsible for international funding and liability management. Giuseppe has over 12 years of banking/ finance experience, primarily in the areas of capital markets and debt management.

What are the implications of the increase in global interest rates for issuers? Will it affect sukuk issuances?

Despite the anticipation of a new hiking cycle by the Federal Reserve, the increase in USD long-term interest rates has been limited so far this year. In reality, in relative terms credit spreads have had a larger impact on borrowers' cost of funding than underlying rates. All-in rates still remain close to historical lows however we continue to see upward pressures on the level of spreads due to worsening liquidity conditions in the system. This may trigger more capital markets activity as loans become more expensive, however this will be a gradual process.

Most companies will start using the cash available to avoid "expensive funding", but this will affect liquidity. How long can the companies survive and when will market liquidity start drying up? Why is sukuk believed to be a better financing option than loans/financing?

Relying solely on available cash balances is not an effective long-term strategy, especially when liquidity conditions start becoming tighter. Regular access to markets via sukuk, for example, is a more sustainable strategy. It offers the issuer visibility in the market, a regular dialogue with the investor community and diversification of its funding sources.

This is particularly true at times when banks' cost of funding is on the rise and access to the loan market becomes more expensive than in the past.

Does the increase in global interest rates simultaneously increase the demand from the buy-side given higher yields? Will this also increase secondary market activities since there will be a higher reinvestment risk?

Not necessarily immediately, this tends to be a gradual process especially when it comes to new issues in the primary market. In addition to the better returns available in the market investors need to consider heightened uncertainty regarding the future trajectory of rates and a typically higher level of volatility. On the secondary, we are already observing more activity in reaction to the wider credit spreads especially in the GCC market, which is typically characterized by low volumes and a large number of buy and hold type of investors.

How will this affect investors investing in equities and will there be a shift to sukuk? Or is the equities market still outperforming other investment avenues?

Equities and sukuk typically address different pockets of liquidity i.e. portfolios. As a result, I do not foresee any major shifts from one asset class to the other. Having said that and as previously mentioned, investors tend to react strategically to significant changes in market prices. This may happen if spreads continue to widen or we observe another major correction in equity prices.

What are the best ways to hedge against the increase in interest rates? Will the market see a shift from fixed sukuk to floating as the interest rate environment becomes unstable?

Over the years managing duration synthetically via derivatives has proven to be a more effective and more flexible strategy. The market is used to fixed sukuk. I do not see a strong rationale for issuers to focus primarily on floating instruments instead. Both issuers and investors in the GCC market are fairly sophisticated and have easy access to derivative liability management tools.

Will oil exporting countries' potentially huge sukuk issuance and resulting liquidity reduction dry up the interbank markets or make them much more expensive?

On the one hand, larger financing needs at government level and higher loan prices in the bank market point in the direction of increased levels of issuance in the capital markets. On the other hand, heightened volatility may result in a more cautious behavior on the investor side.

The net effect I expect is fairly healthy levels of supply going forward, with the proportion of borrowing conducted via capital markets increasing vis-a-vis loans. In particular, I believe there will be renewed interest in capital markets especially by those corporates that in the last couple of years have relied solely on the bank market for their financing needs due to extremely favorable pricing and easy access to liquidity.

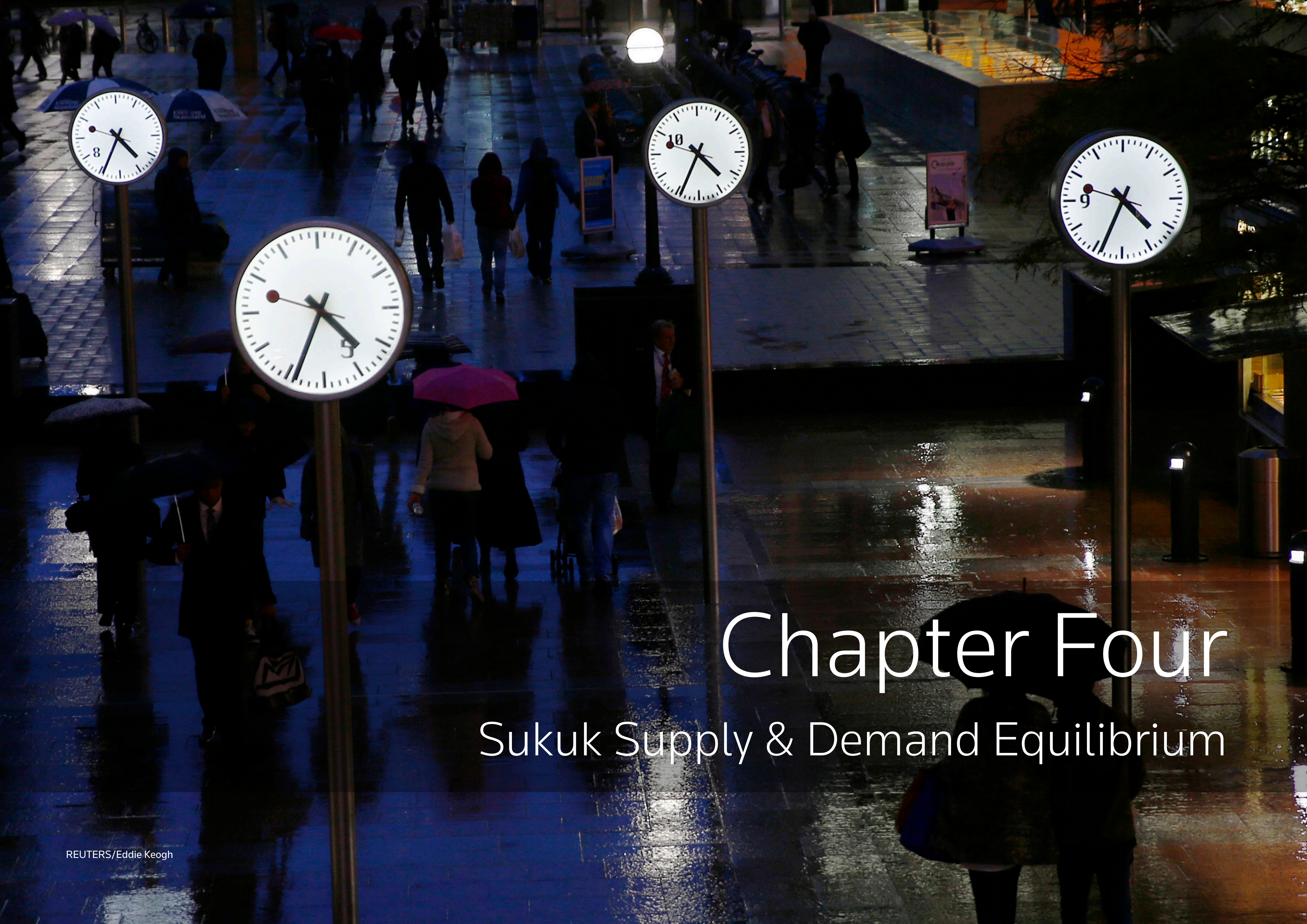
Despite the Federal Reserve's statements about a slow rate of increase once the first rate hike occurs, is it likely that the first increase will dramatically increase the term premiums of sukuk and hurt primary market issuance and/or lower average maturity?

As you mention the market expects gradual rate increases, at least at the beginning of the tightening cycle. I tend to agree with this view especially in light of the Fed's inaction in September, which illustrates their continuing caution despite positive U.S. data. Leaving rates on hold was widely expected but the way Yellen and her governors chose to explain their decision introduced a strongly international dimension to their decision making with explicit reference to "global economic and financial developments". Implicit here is the risk of deflationary pressures from developments in China playing a significant role in the Fed decision.

To conclude, I do not foresee dramatic implications for primary markets at least in the coming months. Secondly, issuers tend to adapt very quickly to changing market conditions and access markets even when conditions become more challenging.

> *"Relying solely on available cash balances is not an effective long term strategy..."*

REUTERS/Yuya Shino



Chapter Four

Sukuk Supply & Demand Equilibrium

REUTERS/Eddie Keogh

Global sukuk Supply

By refinancing options

Why issue sukuk

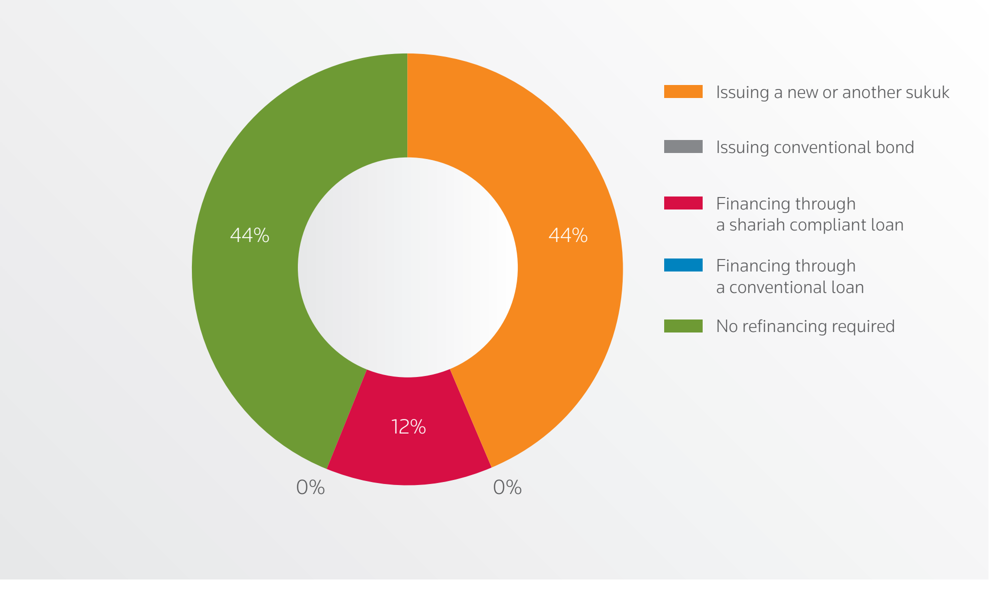
The primary reason for issuing sukuk has changed considerably from last year to this year. In this year's survey, the leading primary reason to issue sukuk, as reported by 45% of issuers was diversification of funding sources while in last year's survey the leading reason for issuing sukuk, as reported by 38% of issuers, was for business expansion. The second primary reason, as reported by 30% of issuers in this year's survey, was to get cheaper funding and better pricing compared to other financing means, which could attract more players to issue sukuk in 2016 and beyond.

44% of issuers and lead arrangers would consider sukuk for their financing options for 2015 and 2016; another 44% said that in the short-term they do not require funding. Only 12% of issuers and lead arrangers would choose to refinance using Islamic financing, and none would consider conventional bonds and loans.

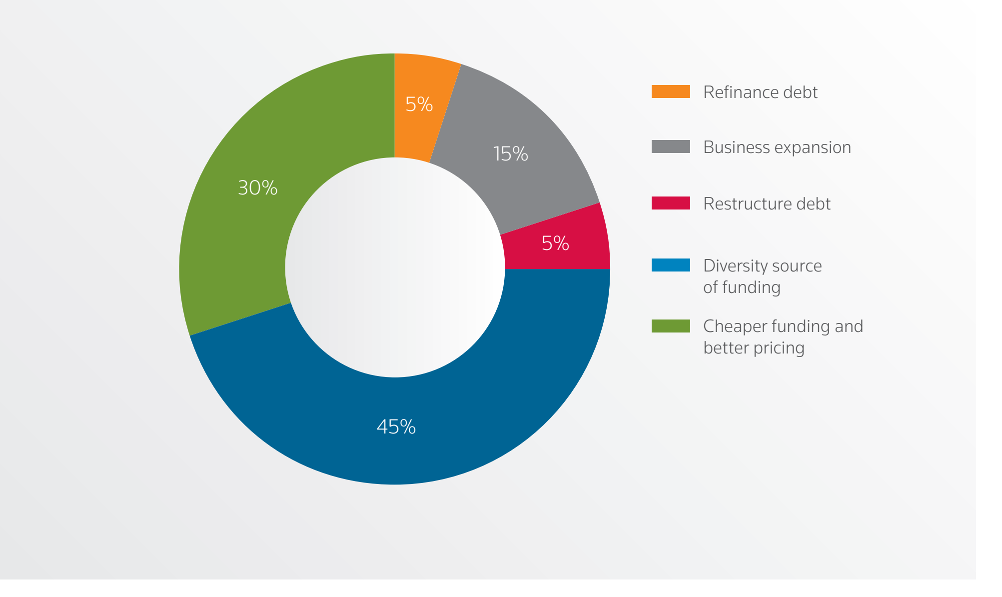
The survey results indicate that the drop in sukuk in 2015 is partly due to the availability of liquidity with some of the issuers and hence have not tapped into the sukuk market.

"The survey results indicate that the drop in sukuk in 2015 is partly due to the availability of liquidity..."

SURVEY FINDINGS – AS AN ISSUER, WHAT ARE YOUR DEBT REFINANCING OPTIONS FOR 2015 AND 2016



SURVEY FINDINGS – WHAT IS YOUR PRIMARY REASON TO ISSUE SUKUK?



By cost issuance

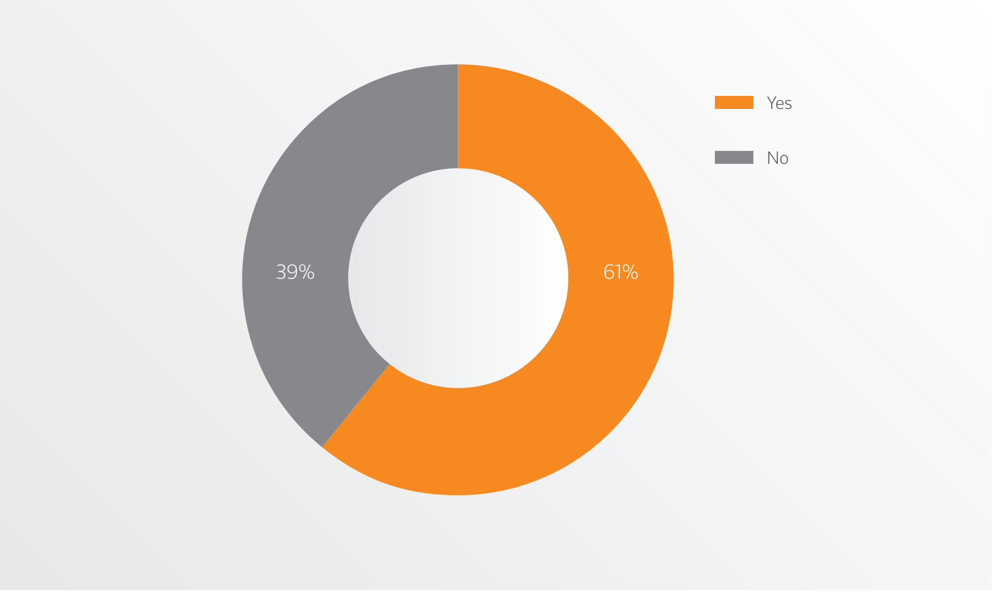
Investors believe that sukuk is cheaper

Cheaper:
61% of issuers and lead arrangers agree that sukuk is cheaper than conventional bonds given the larger investor base which includes both Shariah- and non-Shariah-sensitive investor base.

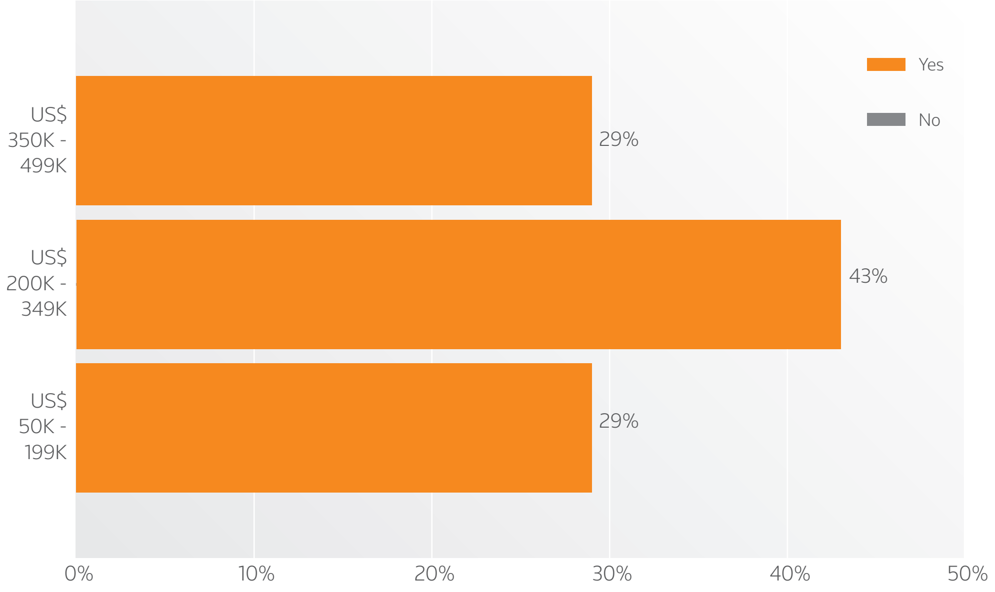
Cost:
43% of issuers and lead arrangers said that the average additional cost of issuing sukuk is between US$ 200k to US$ 349k, which are related to Shariah documentation fees and other costs associated with Shariah supervisory board for approving the paper. However, as per the survey results, sukuk remains cheaper despite the additional costs associated with the paper.

> *“sukuk is cheaper than conventional bonds given the larger investor base which includes both Shariah- and non-Shariah-sensitive investor base.”*

SURVEY FINDINGS – DO YOU THINK SUKUK IS CHEAPER THAN BOND GIVEN THE WIDER INVESTOR BASE (ISLAMIC + CONVENTIONAL)



SURVEY FINDINGS – WHAT IS THE AVERAGE ADDITIONAL COST OF ISSUING SUKUK, FOR AN ISSUER, COMPARED TO A CONVENTIONAL BOND, IN US DOLLAR TERMS?

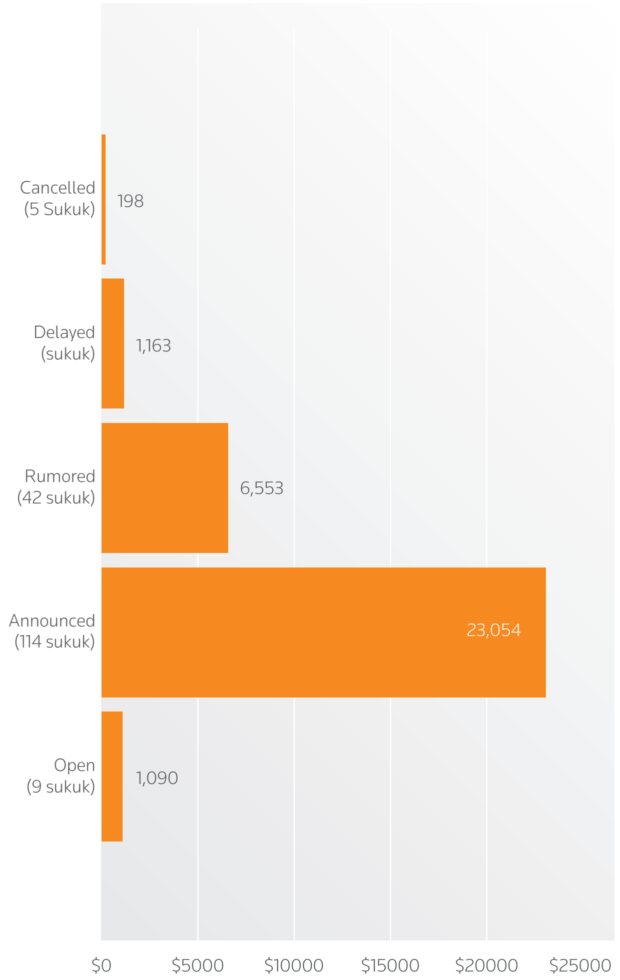


Global Sukuk Pipeline

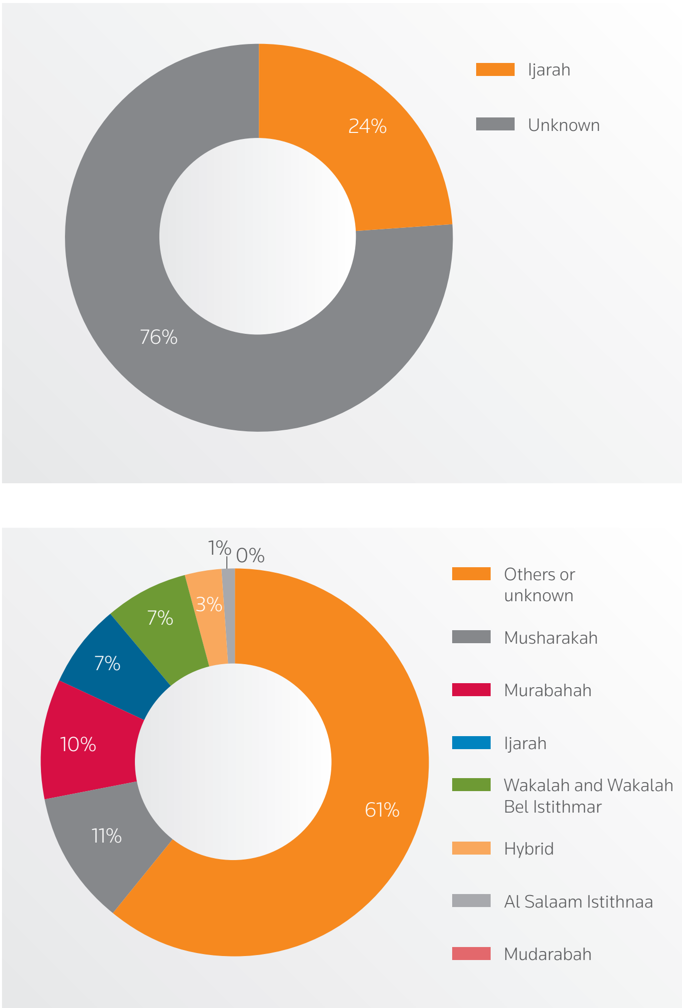
(Up to September 2015)

BY SIZE	Announced	Rumored
Unknown	35%	69%
< US$25 mln	10%	2%
US$ 25- 50 mln	9%	5%
US$50 - 500 mln	34%	17%
US$500 mln - US$1 bln	7%	0%
US$1 bln ≤	5%	7%
Others	44	10

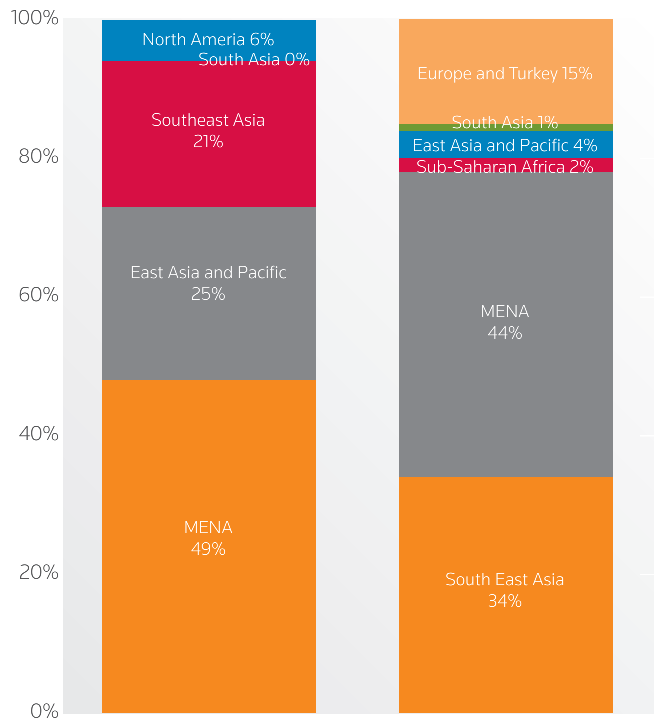
BY VOLUME AND NUMBER – SUKUK VOLUME (MILLIONS $)



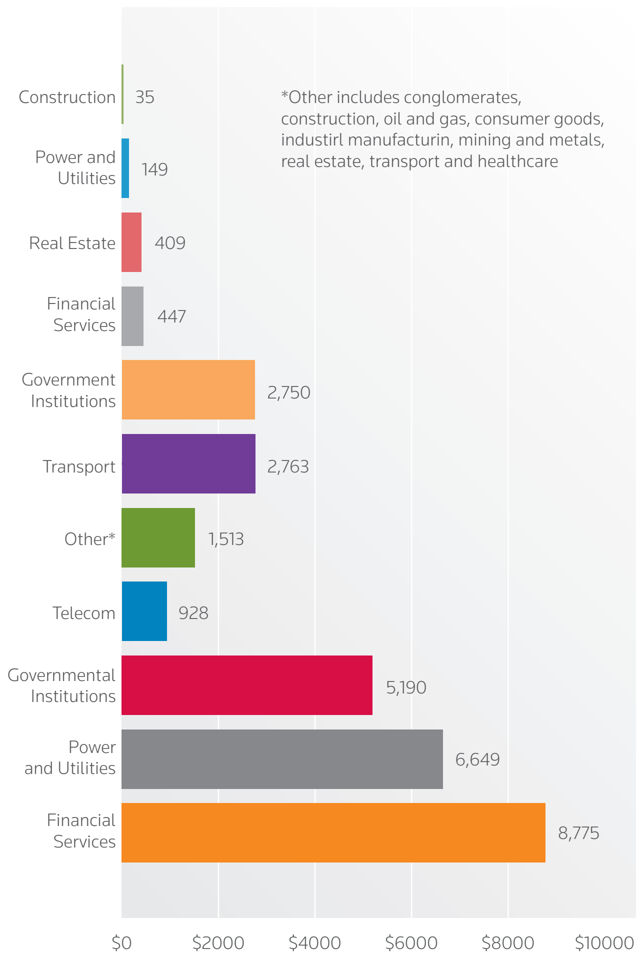
BY STRUCTURE



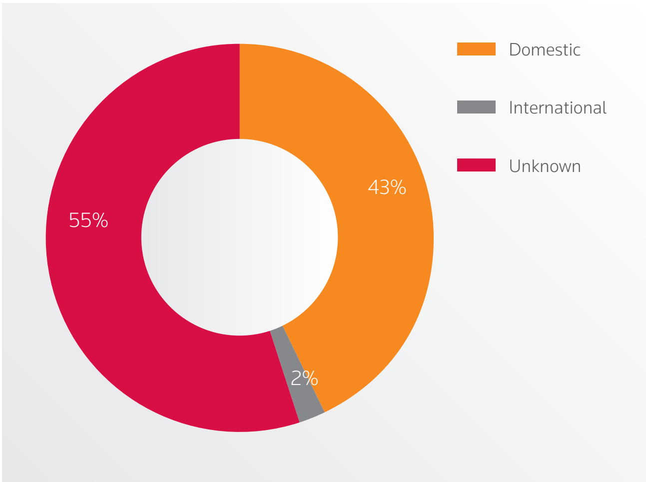
BY REGION AND COUNTRY

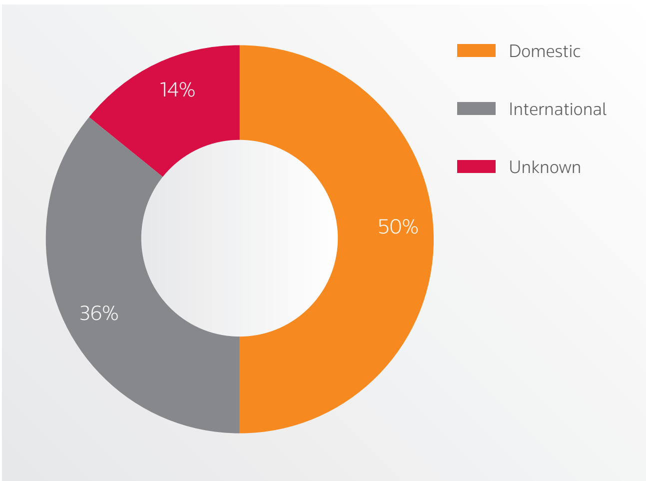


BY SECTOR – VOLUME (MILLIONS)



BY MARKET OF ISSUE





BY SIZE	Announced	Rumored
Corporate	69%	58%
Sovereign	31%	42%

The sukuk pipeline is made up of planned and rumored sukuk announced up to September 2015 when it reached US$32 billion.

Announced Sukuk: One of the biggest planned issuances is for Egypt's US$2 billion sovereign sukuk whose bill took a longer time than usual to pass primarily because of issues related to underlying assets. Other sovereigns have also announced sukuk issuances, including the Ivory Coast, and Tunisia, and others add up to a minority of 31% of total announced sukuk. Sector-wise, Financial Services dominate with total volume of US$8.8 billion followed by Power and Utilities. Most of the structures to be used are unknown, consisting 61% of total announced sukuk. 11% of the sukuk in the pipeline are musharakah followed by murabahah (10%).

Rumored: A total of US$6.5 billion could be added to sukuk volume globally. 24% of all rumored sukuk, is ijarah. Issuances from sovereigns and quasi-sovereigns make up 42% of these rumored sales, including UAE's Green Energy Sukuk, Kazakhstan, Kenya, Mexico, Ningxia, Fujairah, Philippines and Morocco's sovereign sukuk. Most of them are unknown in size.

Delayed and Cancelled: All of the sukuk that are either delayed or cancelled are corporate. A couple of them are delayed and from Financial Services while the cancelled ones are from Real Estate, Oil and Gas and Telecommunications.

Global Sukuk Demand

By Reason to invest

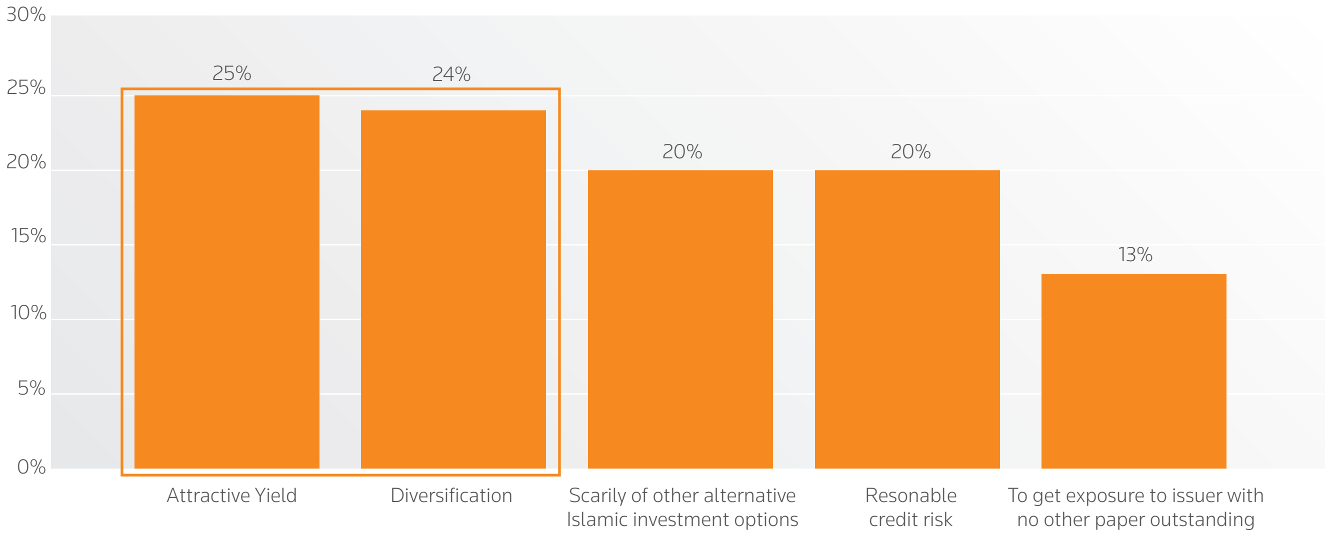
Why invest in sukuk

The demand for sukuk has been enormous especially with the drop in sukuk issuance in 2015 leaving Shariah-sensitive investors wanting. The demand for sukuk comes from both Islamic and conventional investors unlike bonds where conventional players are the sole investors.

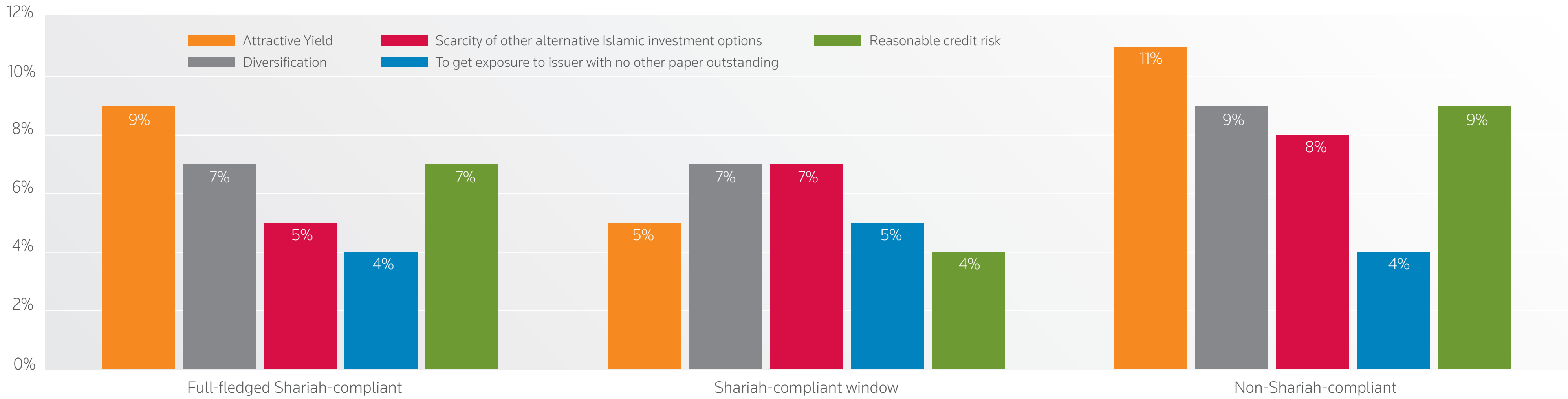
Attractive yield and diversification combined are the demand drivers for 49% of investors, followed by 20% driven by scarcity of other alternative Islamic investment options and reasonable credit risk.

The last reason for investing in sukuk, preferred by only 13% of investors, is to gain exposure to issuers with no other paper outstanding.

SURVEY FINDINGS – WHAT ARE YOUR REASONS FOR INVESTING IN SUKUK?



SURVEY BREAKDOWN



By Allocation

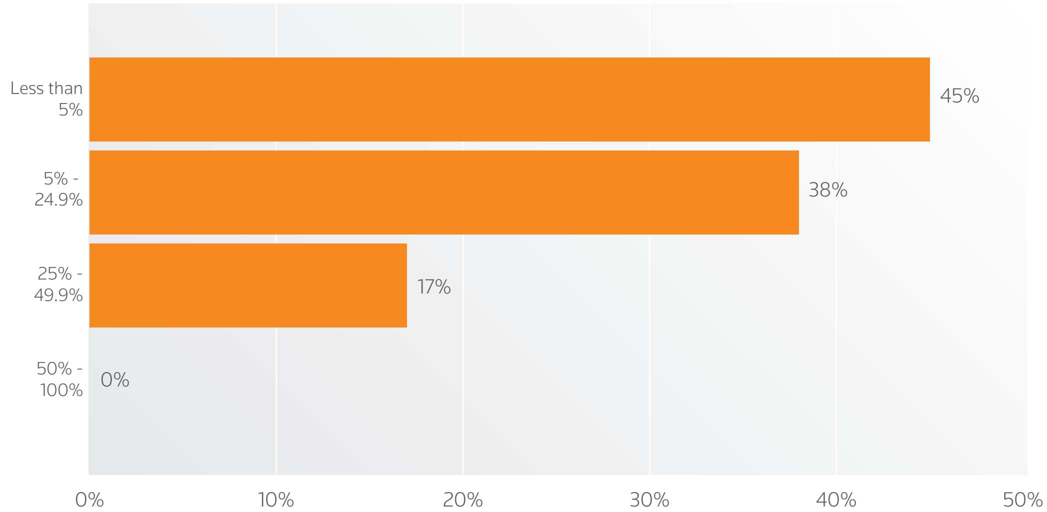
Sukuk demand differentiates the market

Unlike previous years when the majority of investors would place 5% to 24.9% of their assets in sukuk, this year, only 38% of investors would place their Islamic assets in the same category while the majority would allocate less than 5% of their Islamic assets to sukuk.

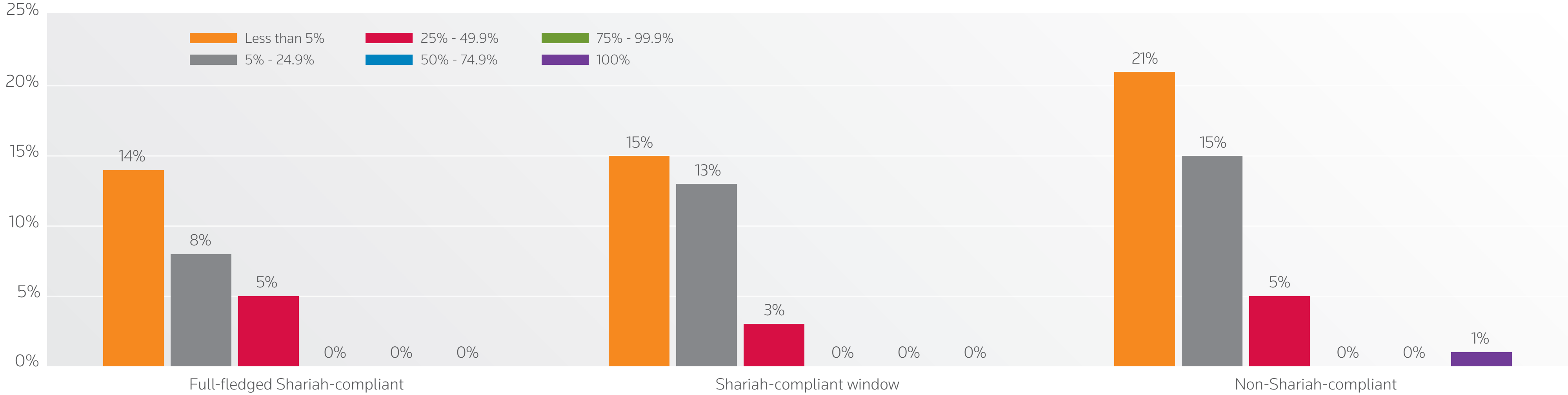
This shift is due to the undersupply of sukuk driving many Islamic banks to look for alternative investments.

We attribute the drop to market expectations of higher interest rates due to economic recovery in Western markets.

SURVEY FINDINGS – FOR THE REST OF 2014 AND 2015, WHAT PROPORTION OF YOUR ISLAMIC ASSETS WILL BE ALLOCATED TO SUKUK? (IN %)



SURVEY FINDINGS – FOR THE REST OF 2015 AND 2016, WHAT PROPORTION OF YOUR ISLAMIC ASSETS WILL BE ALLOCATED TO SUKUK?

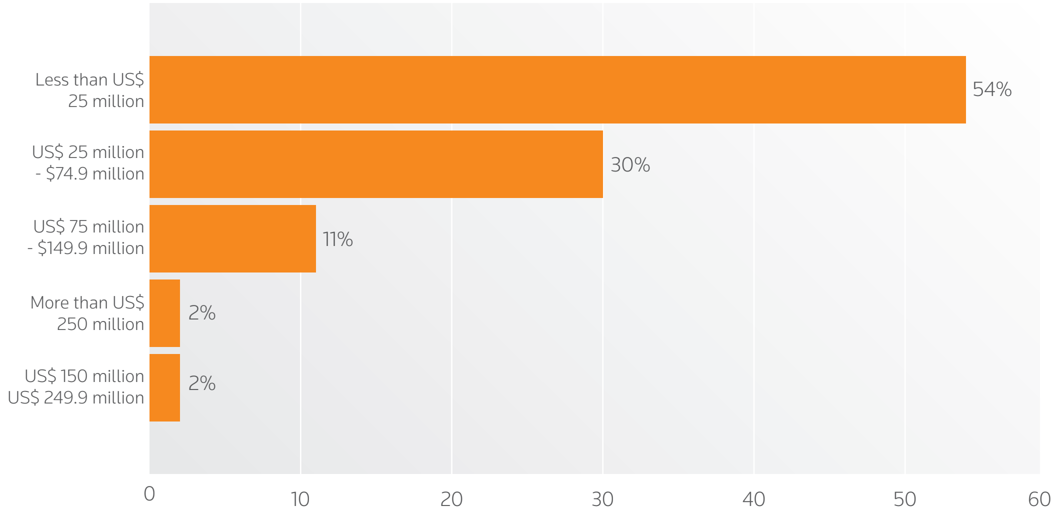


Sukuk investors continue to come mainly from Islamic financial institutions, most of which have small investment books in proportion to their overall size.

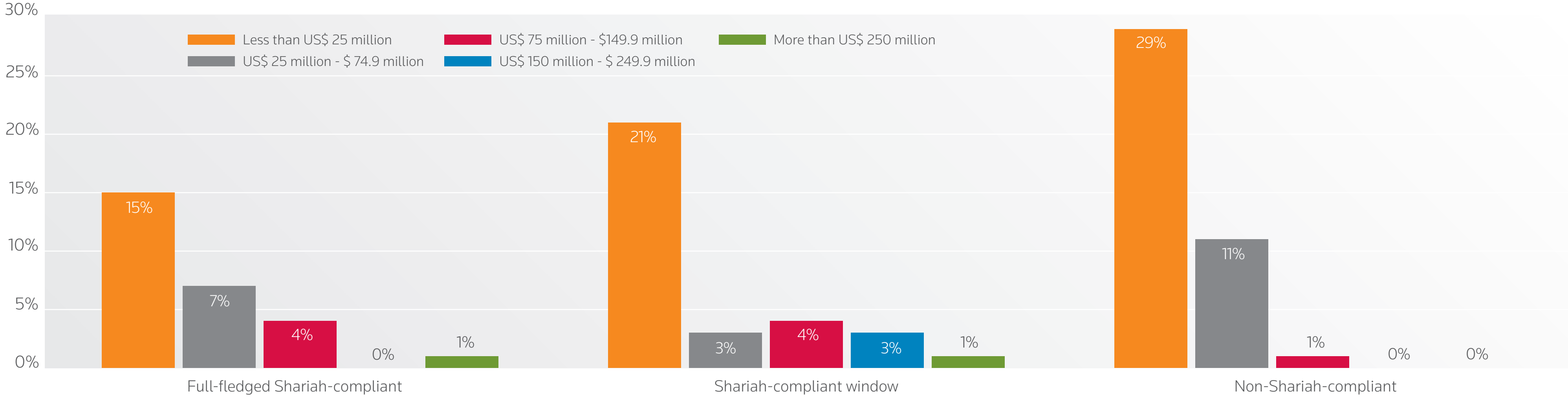
Further, given improved economic and market conditions the majority of investors continue to expect to allocate less than $25 million of their investments to sukuk, followed by 30% of investors who expect to allocate between $25 million to $74.9 million.

The breakdowns of investors show that full-fledged Shariah-compliant banks and Shariah-compliant windows have bigger appetites to allocate assets to sukuk and some of them would allocate as much as US$ 250 million. This is another indication that some of the investors depend heavily on sukuk as their main investment option.

SURVEY FINDINGS – FOR THE REST OF 2015 AND 2016, WHAT PROPORTION OF YOUR ISLAMIC ASSETS WILL BE ALLOCATED TO SUKUK? (IN DOLLAR)



FOR THE REST OF 2015 AND 2016, WHAT PROPORTION OF YOUR ISLAMIC ASSETS WILL BE ALLOCATED TO SUKUK? (IN DOLLAR) - BUY SIDE



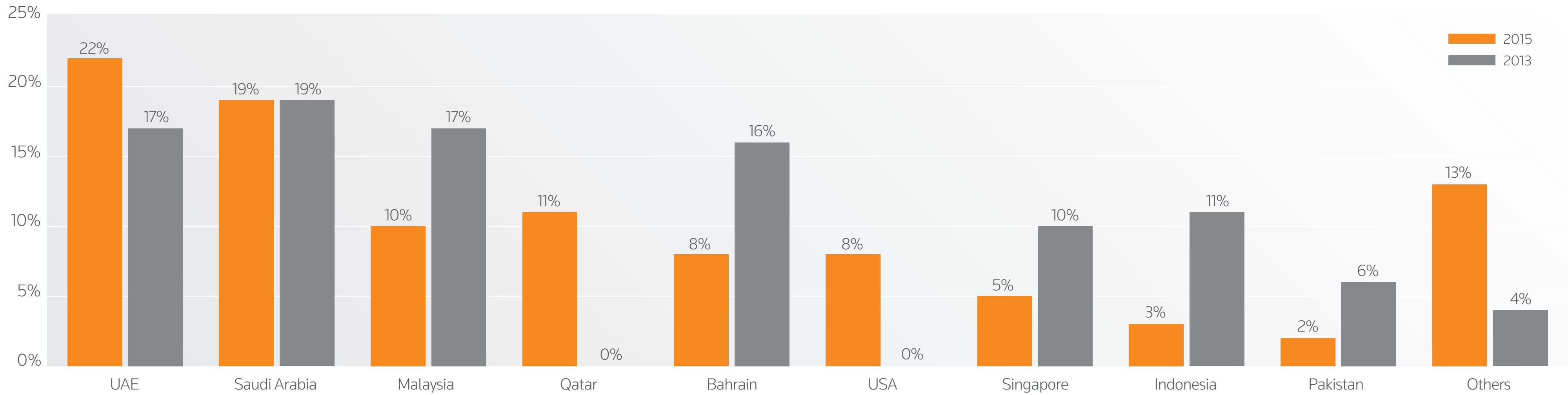
Expectations

How investor expectations have changed from 2013 to 2015

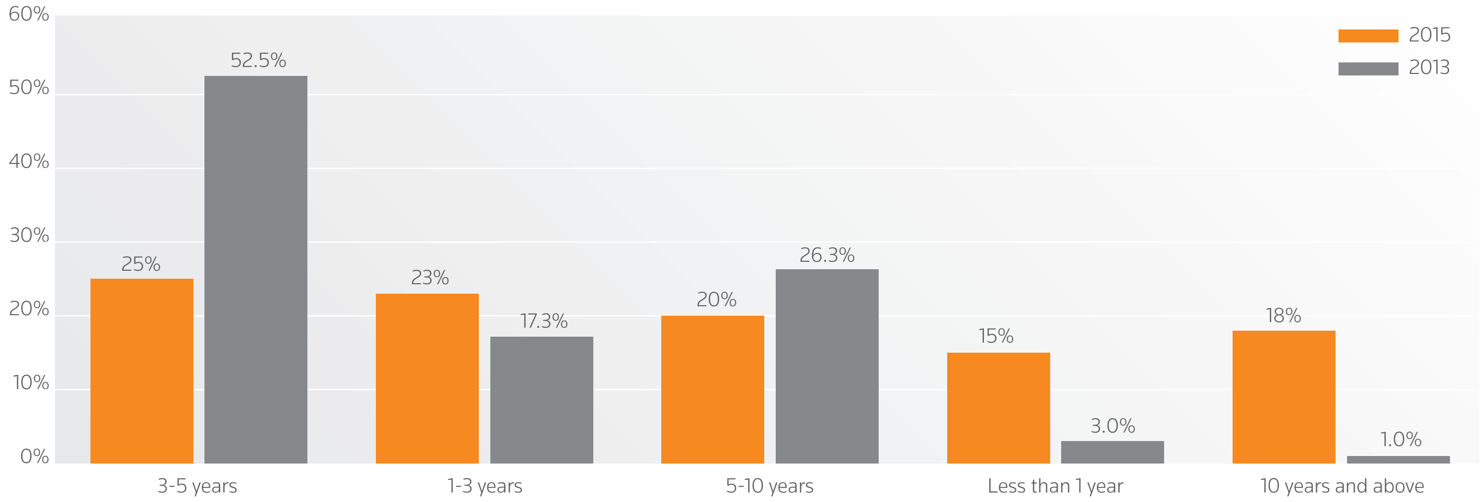
Thomson Reuters Sukuk Survey for 2013 and 2015 show that investors continue to prefer investing in the more established sukuk markets , and gradually becoming more comfortable in 'non-traditional' markets following the issuances in 2014 by a number of non-Muslim countries. The United Arab Emirates and Saudi Arabia are the two countries consistently preferred by investors as their destination for sukuk investments. These two countries are also the only two in the GCC with regular corporate and government related issuances. To some extent, Bahrain also has a solid sukuk market that welcomes investors, although preference for Bahrain has declined in 2015 compared to 2013 because of the weakened credit quality following the drop in oil prices. Malaysia was the second preferred country in 2013, but following the cut in short-term sukuk by Bank Negara Malaysia (BNM), investor preference has dropped significantly.

> *"The United Arab Emirates and Saudi Arabia are the two countries consistently preferred by investors as their destination for sukuk investments. These two countries are also the only two in the GCC with regular corporate and government related issuances."*

COUNTRY PREFERENCE 2013 VS 2015

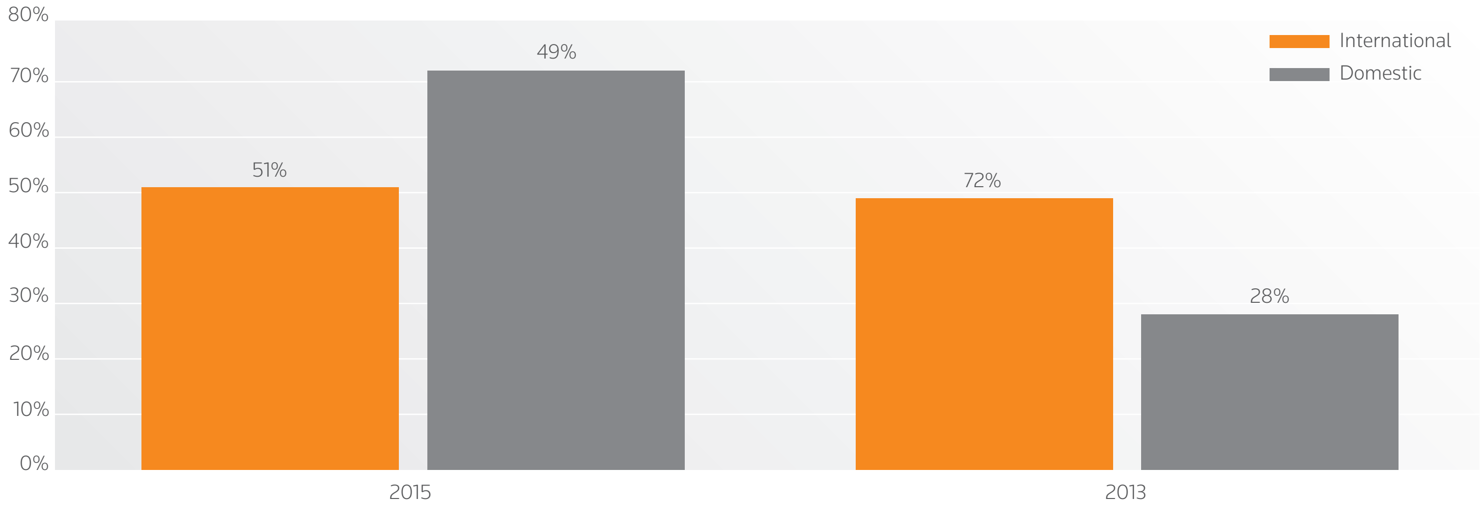


TENOR PREFERENCE 2013 VS 2015



Tenor – In 2013, more than half of investors we surveyed were in favor of medium-term sukuk (3 to 5 years), and 23% preferred slightly longer maturities. These preferences have not changed very much in 2015; in our survey this year 15% of investors prefer money market sukuk, reflecting investor caution and risk aversion amid the uncertain economic environment. Another 23% of investors chose 1 - 3 year sukuk, compared to 17.2% in 2013.

TYPE OF SUKUK PREFERENCE 2013 VS 2015

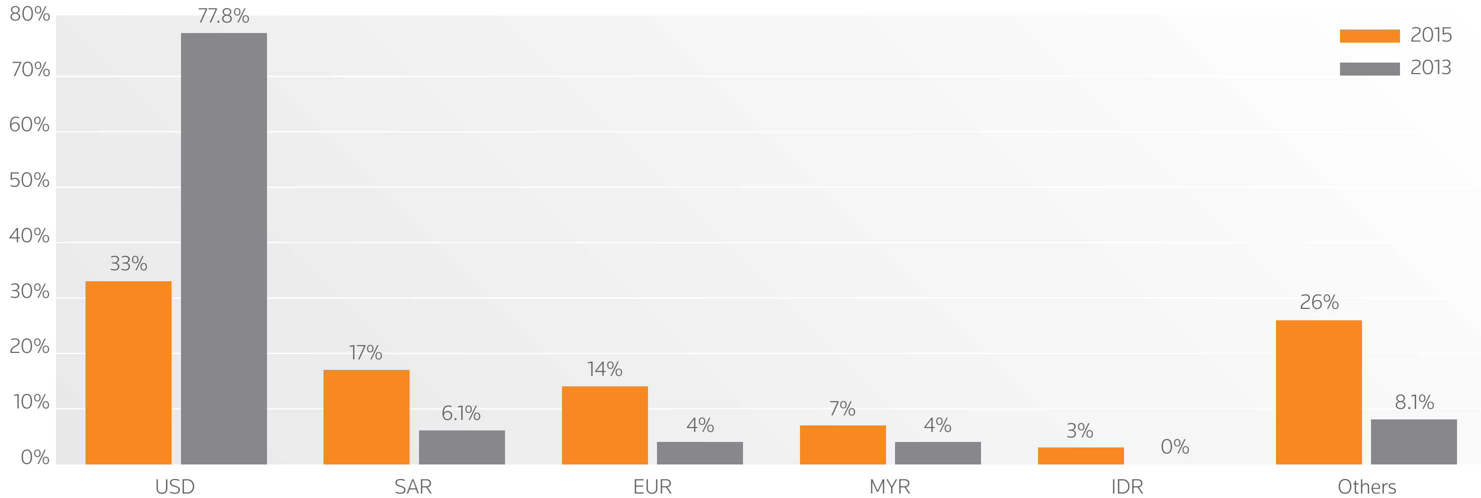


International vs. domestic – There is a swing away from international to domestic sukuk in 2015, signaling increasing confidence in local markets and issuers.

CURRENCY PREFERENCE 2013 VS 2015

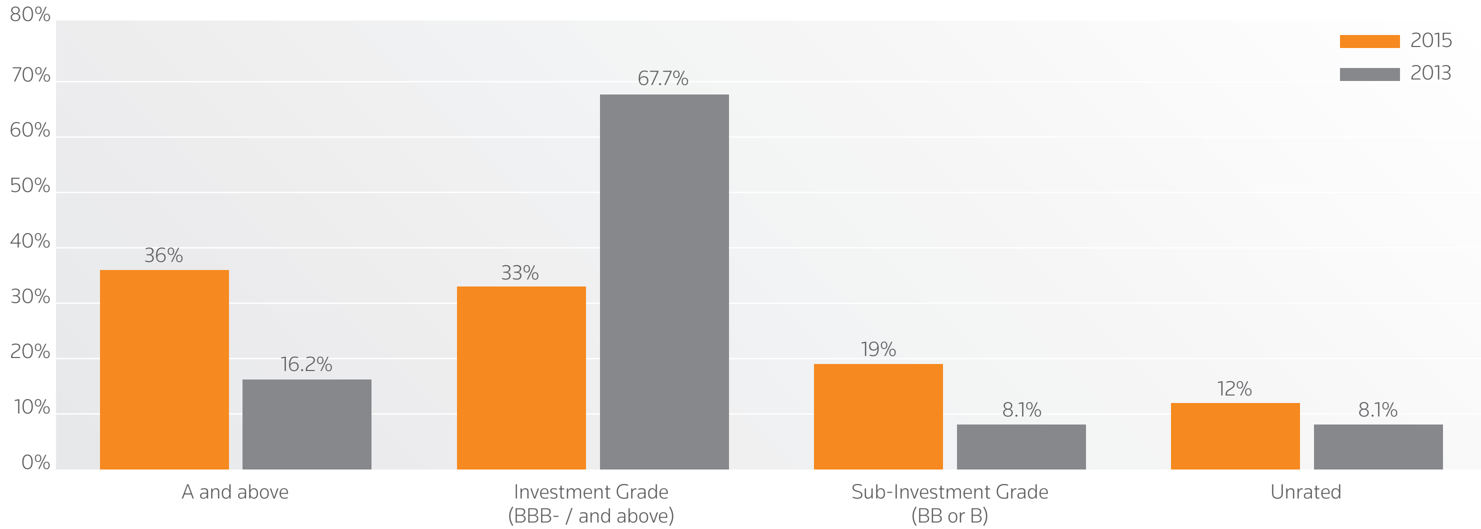
Currency preference is more evenly spread this year, thanks to the new countries that issued sukuk in 2014, including the United Kingdom, Senegal, Luxembourg, and South Africa.

In 2013, the USD was preferred by 77.8% of investors; preferences have shifted this year, with investors more open to the Euro, Saudi Riyal and other currencies.

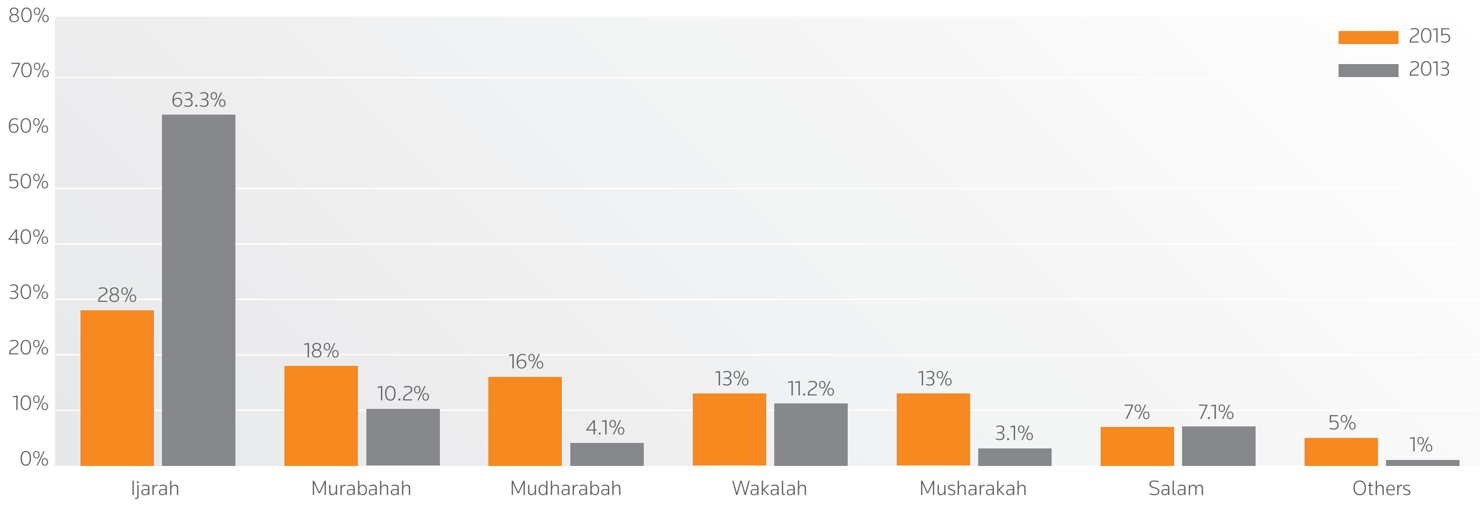


RATING PREFERENCE 2013 VS 2015

Investor risk appetite has changed significantly since 2013. Where investment grade papers (which take on more risk and hence offer more returns) were in high demand two years ago this year investors prefer higher quality papers. This could be related to the expected increase in interest rates, as investors would expect to get the same return once interest rates hike up, simultaneously holding better quality risk.

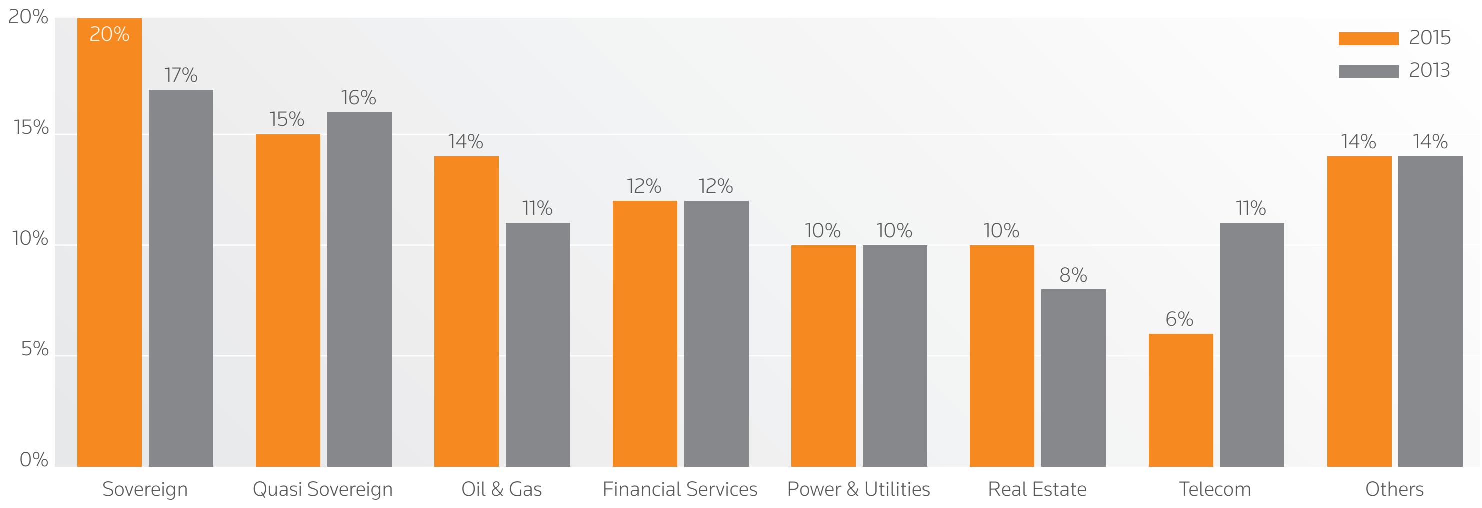


STRUCTURE PREFERENCE 2013 VS 2015



In the GCC, issuers mainly sell ijarah sukuk. There is a fundamental reason why investors continue to prefer ijarah over other structures – AAOIFI guidelines allow the trading of ijarah papers. AAOIFI guidelines do not permit the trading of murabahah sukuk as it is debt-based. Agency structures such as Mudarabah and wakalah are also gaining ground due to their preference by investors.

SECTOR PREFERENCE 2013 VS 2015



In line with the movement of investor risk appetite towards higher quality paper, investor sector preference has been moving towards sovereign sukuk compared to quasi sovereign and telecommunications in previous years.

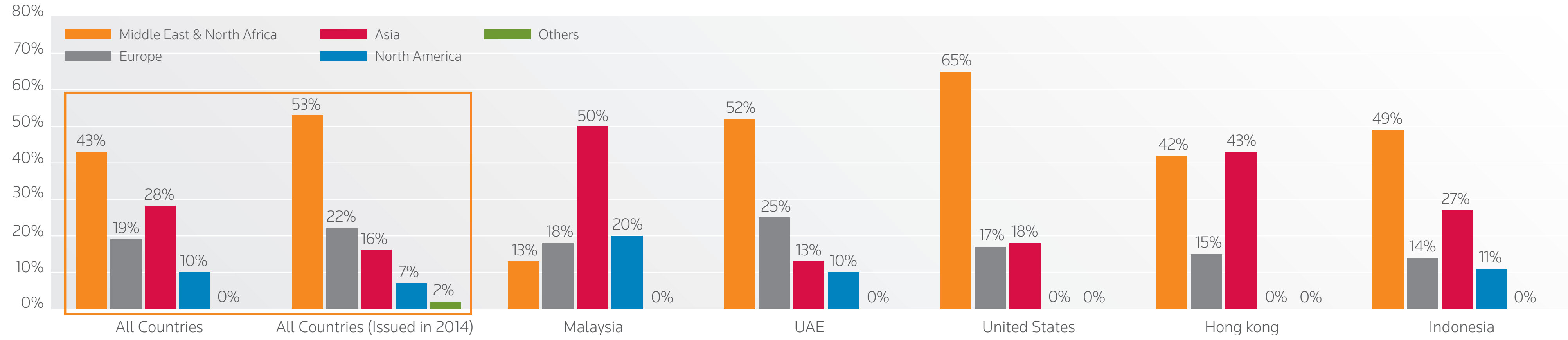
The returns by sovereign issuers have been adequate for investors, allowing more investors to enjoy better quality investments in their books. The telecom sector has shown the biggest drop in terms of preference which is in line with the drop in sukuk by telcos. Oil and Gas is gaining interest, as investors expect Oil and Gas companies to increase their sukuk activities following the drop in oil prices.

Global Investors Geographical Distribution

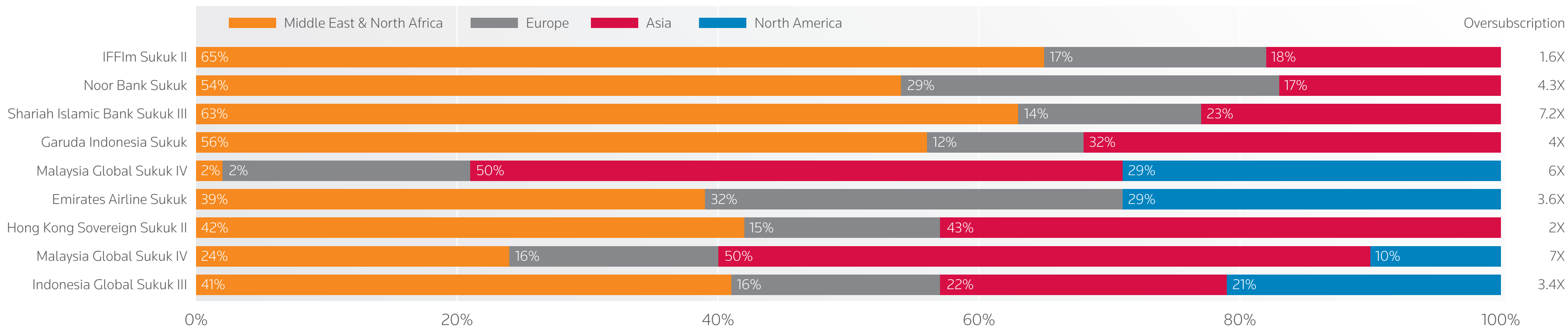
Middle East and Asia compete for international sukuk

Our analysis of the international sukuk market reveals that Middle Eastern investors are the biggest buyers – 43% of the total investor base -- of international sukuk from key markets UAE, United States, Hong Kong and Indonesia. Investors from Asia and Europe follow, at 28% and 19% of the total investor base, respectively. The geographical distribution indicates that Middle Eastern investors are more open to different markets than Malaysian investors who prefer investing in their home country or neighboring countries.

AVERAGE GEOGRAPHICAL DISTRIBUTION* OF INVESTORS OF INTERNATIONAL SUKUK ISSUED IN 2015 – *Geographical Distribution is collected from available news



SELECTED INTERNATIONAL SUKUK GEOGRAPHICAL DISTRIBUTION 2015

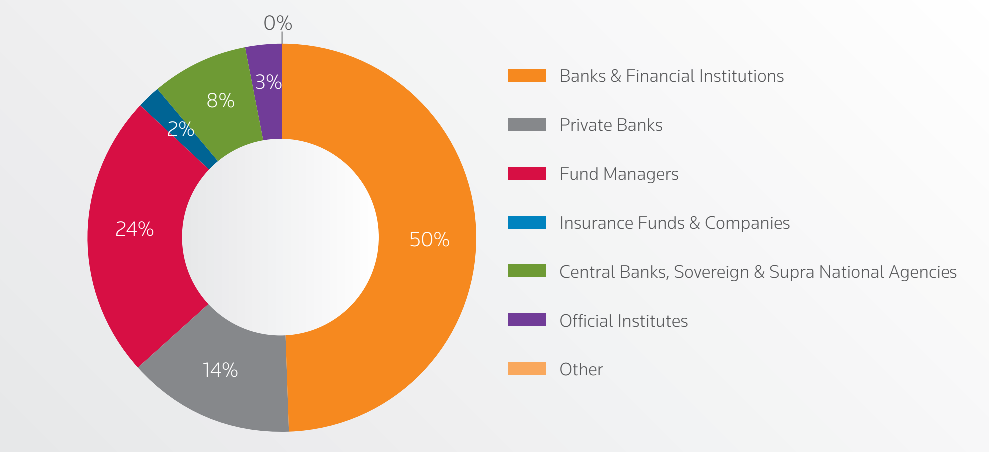


Global Investors Sector Distribution

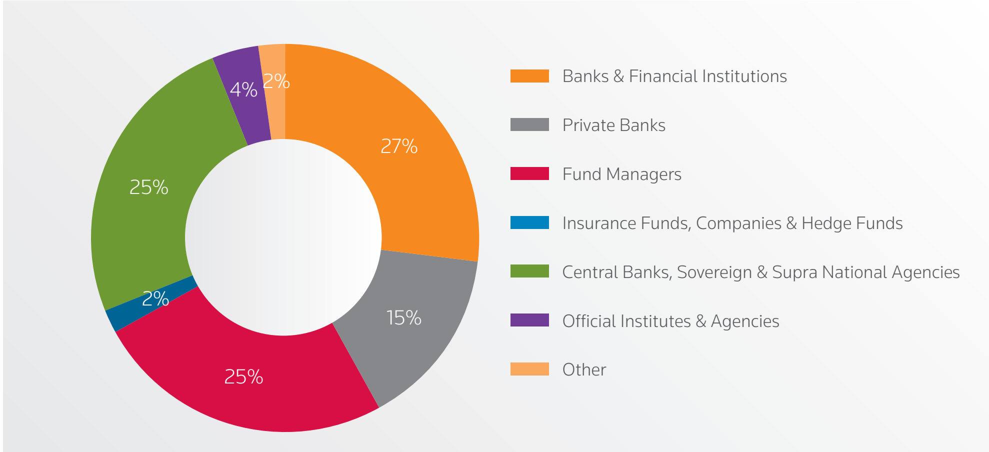
Banks and financial institutions increase their exposure to international sukuk

The vast majority of investors are financial institutions and fund managers. The sectoral distribution in 2015 reveals a different trend to 2014. The shrinking proportion of central banks, sovereigns and supra national agencies has allowed in a much bigger proportion of banks and financial institutions, from 27% in 2014 to 49% in 2015. All other sectors remain more or less the same.

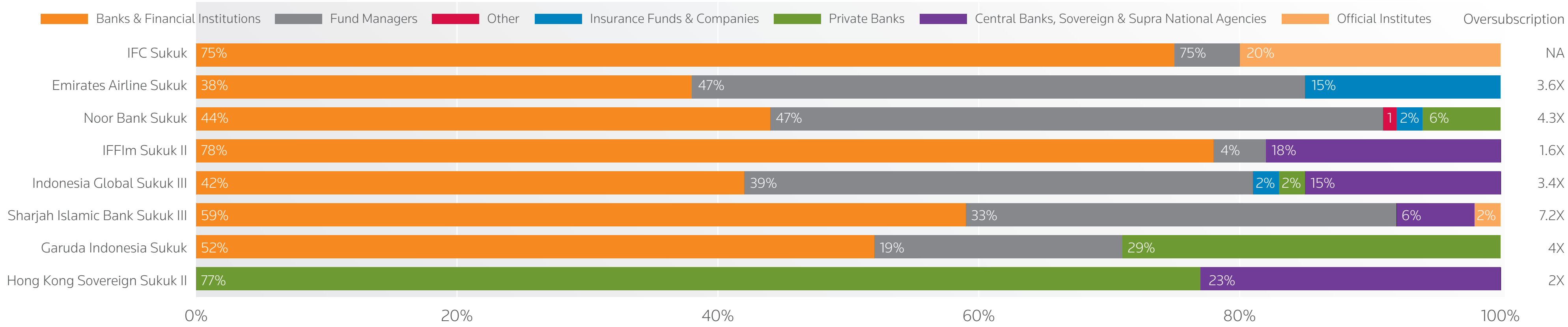
AVERAGE SECTOR DISTRIBUTION* OF INVESTORS OF INTERNATIONAL SUKUK ISSUED IN 2015 – *Sector distribution is collected from available news



AVERAGE SECTOR DISTRIBUTION* OF INVESTORS OF INTERNATIONAL SUKUK ISSUED IN 2014 – *Sector distribution is collected from available news



SELECTED INTERNATIONAL SUKUK SECTOR DISTRIBUTION 2015



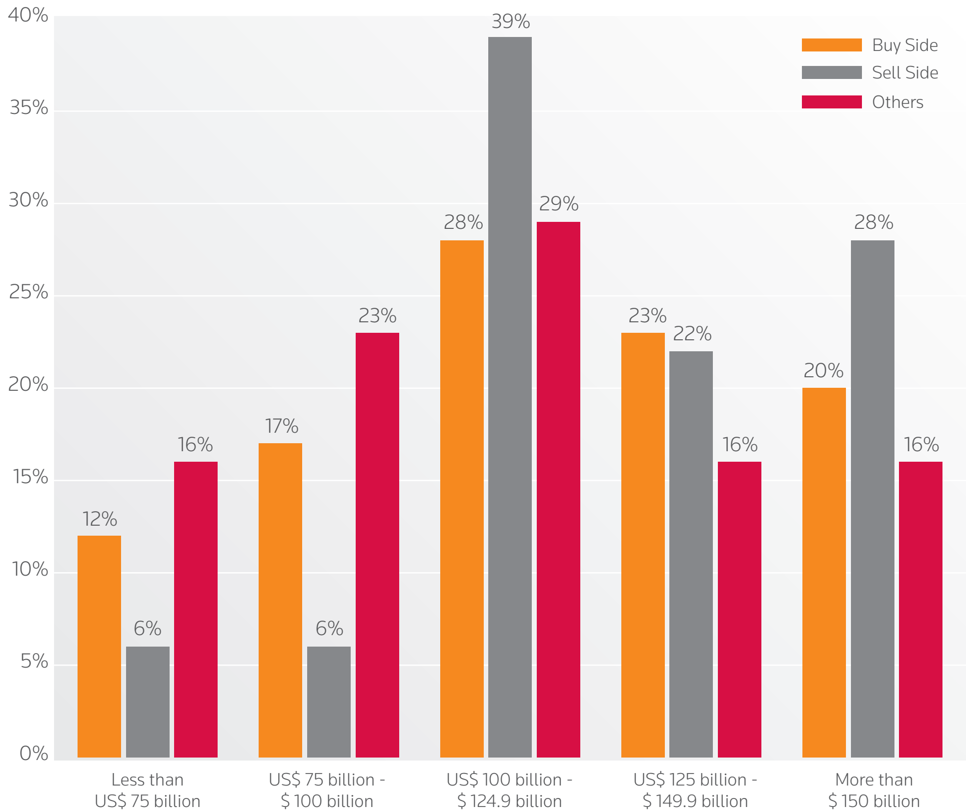
2015 witnesses lowest sukuk volume in five years

The ball is in sukuk issuers' field to capitalize on demand

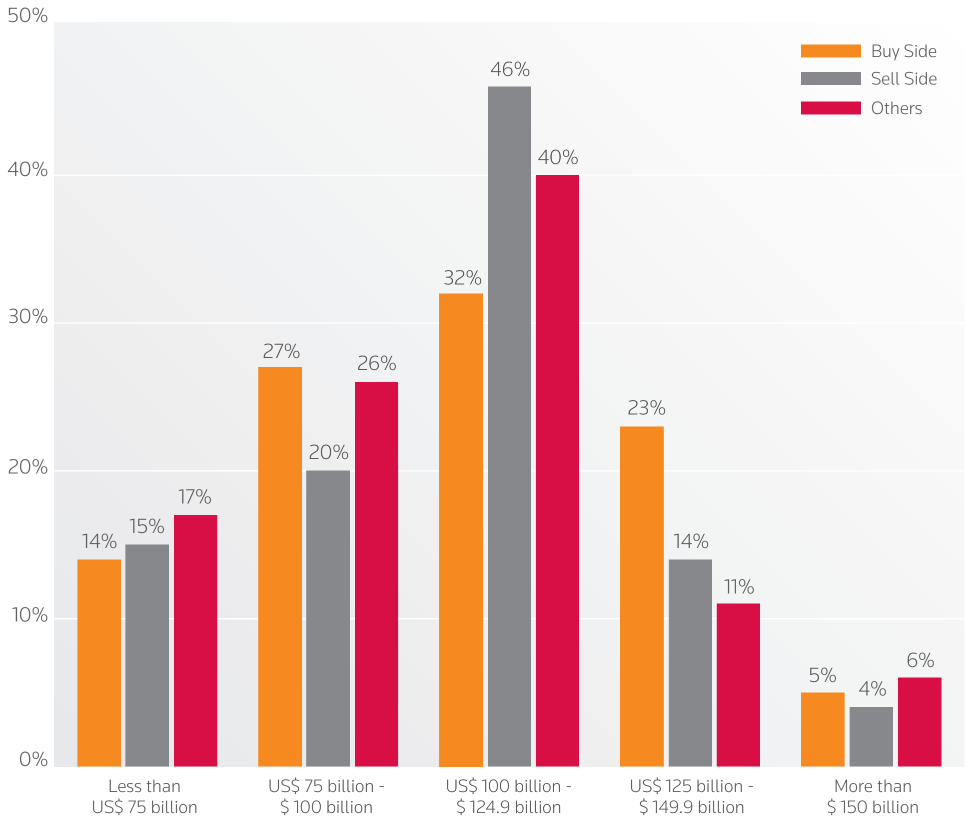
The plunge in sukuk volume in 2015 is attributed to 3 key factors: low oil prices, expected rise in interest rates and Bank Negara Malaysia stopping the flow of its short-term sukuk issuances. However, given the strong pipeline of $32 billion, the outlook remains positive, as all market players expect the growth in sukuk issuance in 2015 to be in the range of $100 billion to $124.9 billion.

All market players expect a slight boost in sukuk issuance in 2016 – most expect total global issuances to be greater than US$100 billion.

SURVEY FINDINGS – WHAT VOLUME OF GLOBAL SUKUK ISSUANCE DO YOU EXPECT IN 2016? THE TOTAL GLOBAL SUKUK ISSUANCE IN 2013 WAS US$ 107.2 BILLION AND 2014 WAS US$ 112.7 BILLION



SURVEY FINDINGS – WHAT VOLUME OF GLOBAL SUKUK ISSUANCE DO YOU EXPECT IN 2015? THE TOTAL GLOBAL SUKUK ISSUANCE IN 2013 WAS US$ 107.2 BILLION AND 2014 WAS US$ 112.7 BILLION



Sukuk Demand and Supply Equilibrium

Market outlook: Supply & Demand Model Assumptions

Sukuk demand continues despite the drop in supply

SUPPLY SIDE

In 2015, sukuk supply plunged more than 50% as Malaysian issuance was drastically cut back and debt markets treaded extra cautiously in response to low oil prices and the anticipated rise in interest rates.

Gobal sukuk issued in 2015 as at **November 8 was $55 billion**, according to Thomson Reuters Zawya data. For full year 2015, we expect sukuk issuance to increase over YTD amounts to reach around $65 billion.

These numbers are well below market expectations. Our Sukuk Survey respondents were ready for a drop in global sukuk supply but reality has been grimmer than expected. **This year's Sukuk Survey respondents expect issuance for full year 2015 and full year 2016 to be between $100 – 125 billion**, which is down from their 2014 prediction of $125-150 billion for 2015. from last year predications and for 2015 between $150 and $175 billion.

While average growth of the sukuk market across 2011 to 2015 was 11%, according to Thomson Reuters Zawya data, 2014 growth was -13% and the slide continued in 2015. We expect full year 2015 issuances to plunge by around –36%.

Therefore, conservatively, we estimate total issuance growth rate to be -36% in 2015. We expect issuance to pick up in 2016 to 15% growth as governments of oil-exporting countries start issuing sukuk to cover their deficits. This growth will slide **down to 8% in 2017 and steady growth will settle in for the following 3 years (2018-2020)** along the expected growth of Islamic financial assets.

According to ICD Thomson Reuters Islamic Finance Development Indicator (IFDI2015), global sukuk outstanding is expected to grow based on average growth rates of previous years. Sukuk is the second largest asset class for Islamic finance, accounting for 16% of total Islamic finance assets and **outstanding sukuk is projected to grow an average of 5% per year to reach US$395 billion by 2020** or a declining share of 12% of total Islamic finance assets.

For total global sukuk matured, we derive the numbers from Thomson Reuters Zawya as per existing sukuk maturity profiles. In addition, we have calculated the average of short-term sukuk that are issued and matured at the same year for (2011-2015) which is equal to 29%.

DEMAND SIDE

Sukuk demand is driven by two types of investors – Shariah-sensitive investors and other global investors seeking diversification and attractive yields. We project the demand from the broadest group of Shariah-sensitive investors - the Islamic financial institutions (IFIs), as the core base for continued sukuk investment.

According to data from the **ICD-Thomson Reuters Islamic Finance Indicator (IFDI2015)**, total Islamic finance assets of banks, takaful, other Islamic financial institutions, funds and sukuk equalled $1.814 billion in 2014 (the total assets of 1,142 institutions worldwide including Islamic windows).

The ICD-Thomson Reuters Islamic Finance Development Indicator's growth projection for Islamic finance assets up to 2020 is based on calculating the average weighted growth for each of the sectors/asset classes' growth from 2012 till 2014 separately then adding them to reach the projected total Islamic finance assets for 2015 to 2020. The growth rate for each asset class is calculated using the weighted average growth for each country contributing to the asset class' total assets (while removing foreign exchange effect) then adjusting the growth rate to different economic factors like oil prices. The final outcome of this method is that Islamic finance assets will reach US$3.2 trillion in 2020, based on average growth of 10% per year from 2014.

The Islamic finance sectors and asset classes are: Islamic banking, takaful, other Islamic financial institutions, sukuk and Islamic funds. Islamic banking is the main driver for Islamic finance growth; it holds the largest pool of Islamic finance assets (74% of total Islamic finance assets in 2014 and projected to become 80% of such in 2020 or US$2.6 trillion), and is projected to grow 11-12% per year.

According to IFDI2015, liquid assets make up only 16% of total Islamic finance assets. We predict that sukuk makes up approximately 10% of this 16%.

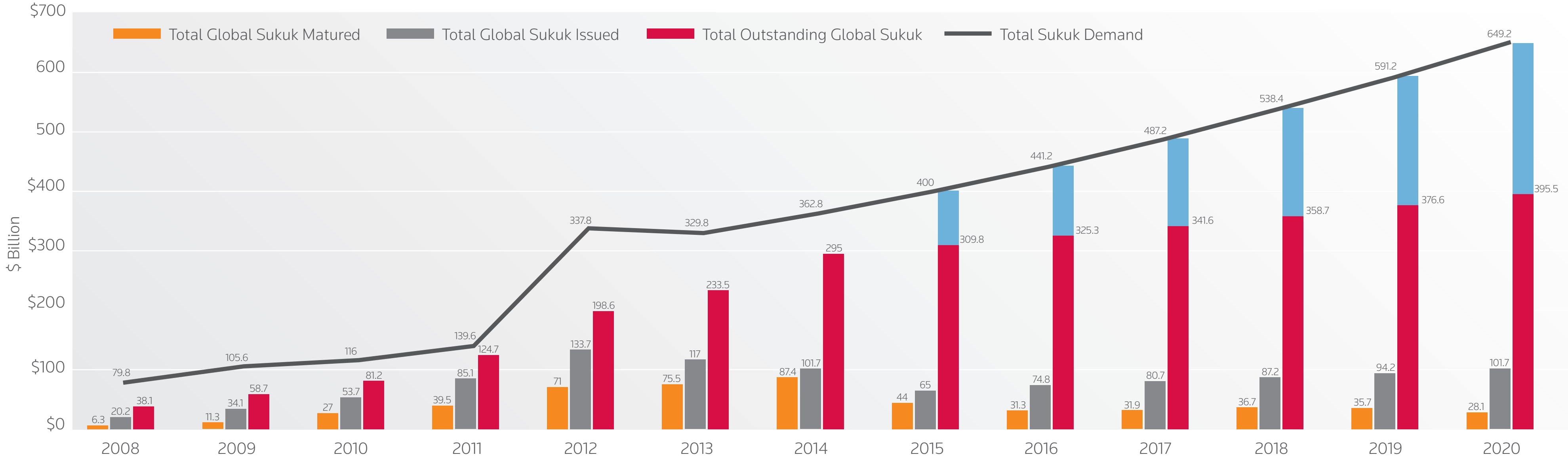
With the 84% of Islamic finance assets that are non-liquid, we estimate 5% to be sukuk (based on HTM classification).

As for non Shariah-compliant investors, who are mostly non-OIC markets (primarily the U.S., Europe and Asia), we estimate they hold 20% of sukuk allocation. Therefore, non Shariah-compliant investors cover 4% plus the 16% allocation from Shariah-sensitive investors. **Therefore, the revised average portfolio allocation of sukuk is 20% from 25% in 2014.**

Despite the tremendous drop in sukuk issuance, outstanding sukuk still expected to reach $400 billion levels by 2020

	2008	2009	2010	2011	2012	2013	2014	2015F	2016F	2017F	2018F	2019F	2020F
Percentage Sukuk Growth	-48%	69%	57%	58%	57%	-13%	-13%	-36%	15%	8%	8%	8%	8%
Total Global Sukuk Issued	**$20.2**	**$34.1**	**$53.7**	**$85.1**	**$133.7**	**$117.0**	**$101.7**	**$65.0**	**$74.8**	**$80.7**	**$87.2**	**$94.2**	**$101.7**
Total Global Sukuk Matured	$6.3	$11.3	$27.0	$39.5	$71.0	$75.5	$87.4	$44.0	$31.3	$31.9	$36.7	$35.7	$28.1
Total Global Sukuk Outstanding	$38.1	$58.7	$81.2	$124.7	$198.6	$233.5	$295.0	$309.8	$325.3	$341.6	$358.7	$376.6	$395.5
Total Sukuk Demand	**$79.8**	**$105.6**	**$116.0**	**$139.6**	**$337.8**	**$329.8**	**$362.8**	**$400.0**	**$441.2**	**$487.2**	**$538.4**	**$591.2**	**$649.2**
Sukuk Supply & Demand Gap	**$41.7**	**$46.9**	**$34.8**	**$14.9**	**$139.2**	**$96.3**	**$67.8**	**$90.2**	**$115.9**	**$145.6**	**$179.7**	**$214.6**	**$253.7**

SUKUK DEMAND & SUPPLY LEVELS (2014 - 2020)




REUTERS/Luke MacGrego

Chapter Five

Secondary Market Performance

REUTERS/Yuya Shino

Market Opinion

Global Sukuk Issuance Decline in 2015

By Sulaiman Moolla, Director, Sales & Distribution, Treasury & Investments Group

SULAIMAN MOOLLA

Sulaiman heads the Sales & Syndicate team for Barwa Bank's Treasury & Investment business. He is responsible for sales and distribution of the Treasury & Investment product range. Prior to joining Barwa Bank, he worked for HSBC Amanah's Global Markets business and held responsibility for their Islamic Sales & Structuring business. Sulaiman began his career in London with HSBC Amanah and spent more than 7 years working in a number of different Structuring & Sales roles where he was responsible for the manufacture and distribution of HSBC's Islamic Treasury product range. Sulaiman holds a BSc in Physics and a Masters in Islamic Finance.

2015 has proven a tough year for sukuk issuance. Reversing what has so far been a consistent upward trajectory, recent data released by Thomson Reuters Zawya indicates that sukuk issuance has lost steam and momentum. Up to September 2015, GCC borrowers had only raised US$5.8bn through international sukuk issuance, a 49% year-on-year dip over the corresponding period in 2014.

This sharp decline is the byproduct of a number of factors that stunted growth at both the macroeconomic and regional levels. For most of 2015, these factors have been driven by uncertainty over the direction of U.S. interest rates, twinned with plunging resource and commodity prices. Moreover, China, the world's biggest energy and industrial metal consumer, has been outpaced by its own growth. Instability in both developed and emerging markets has prompted a prevailing wait-and-see mood, fueling a bear position across markets and the global economy.

As a result, issuers have resolved to stay on the sidelines across many markets. The GCC has been neither an exception nor immune to this halt. Cuts in capital expenditure and reduced growth plans have far from incentivized issuers to pursue ambitious expansion funded though borrowing. In this context, declining global sukuk issuance and, consequently, existing yield have been hit hard by limited supply.

Naturally, the trickle-down effect of global economic woes and sukuk issuance slowdown has impacted the GCC market, already exacerbated by an oil price shock, the pressured liquidity environment and fiscal expenditures.

While GCC investors remain ready for new issuances, they've set stringent criteria on what qualifies as quality credit bought in conducive and stable market environments. To this backdrop, investors remain headstrong in pursuing safe havens, only investing in new issuance when pricing justifies investments. Additionally, excess liquidity in the region has dropped as a result of higher LCR levels required by Basel III compliance and implementation. The flight to quality has never been fiercer. Once risk-taking issuers are today carefully considering their issuance plans. Investors are nervous.

In saying that, the fall in oil prices and budget deficits have equally incentivized GCC governments to consider both local currency and international issuance in 2015. The Kingdom of Saudi Arabia was the first out of the blocks in August 2015, issuing SAR20 billion across various maturities – with additional issuance planned in the near future. In September 2015, Qatar followed with its issuance of QAR15 billion also across various maturities. Oman has issued this year making its debut in sovereign issuance in 2015 issuing a local currency sukuk and, Kuwait has been vocal about putting in place a framework to allow both local and international sukuk issuance. Additionally, we have seen a number of large regional redemptions in 2015. Naturally, this liquidity is looking for a welcoming and solid home.

It is safe to say that with the change in the regional fiscal position, the fall in oil prices and the very valid concerns about the health of global economic demand, the paradigm has shifted. Whereas in previous years, investors were less price sensitive, today's market implications are such that new issue premiums and spreads are ever more relevant and in the spotlight.

55% of investors believe that issues with regards sukuk tradability and liquidity, are due to most investors holding sukuk till maturity. 40% of issuers believe the same. The prevalence of HTM is mostly driven by the limited range of investment instruments for Shariah-sensitive investors particularly the ones with excessive liquidity (Islamic banks and takaful institutions). This also explains why investors also believe that lack of supply is hindering tradability and liquidity.

20% of issuers find that low tradability is due to weak local fixed income markets and another 20% believe that most sukuk are not tradable because of their structures causing low tradability. Moving to know who can make the growth rather than only defining what stops the growth, 40% of investors and 40% of other key market players believe the stock exchanges and platforms are main the driver to a more active secondary market. Accordingly, many stock exchanges and platforms should take serious steps to promote their local Islamic fixed income market following the lead of pioneering countries such as Malaysia, Bahrain and other jurisdictions.

On the other side of the equation, 40% of issuers believe that investors and traders can activate the secondary market through trading their investments instead of holding them to maturity. 25% of investors agrees and believe issuers can control and enhance the secondary market through selling the sukuk to the right investor base, who would not choose to hold the sukuk to maturity.

By Liquidity and Tradability

Investors holding sukuk until maturity is the main limitation for tradability

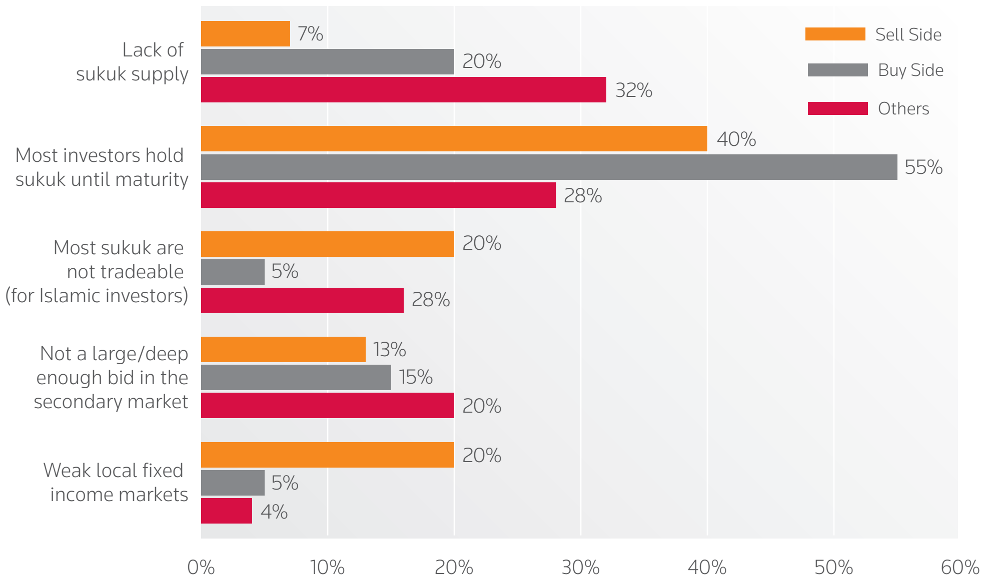
55% of investors believe that issues with regards sukuk tradability and liquidity are due to most investors holding sukuk till maturity. 40% of issuers believe the same. The prevalence of HTM is mostly driven by the limited range of investment instruments for Shariah-sensitive investors particularly the ones with excessive liquidity (Islamic banks and takaful institutions). This also explains why investors also believe that limited supply is hindering tradability and liquidity.

20% of issuers find that low tradability is due to weak local fixed income markets and another 20% believe that most sukuk are not tradable (e.g. murabahah sukuk are not tradable under AAOIFI guidelines).

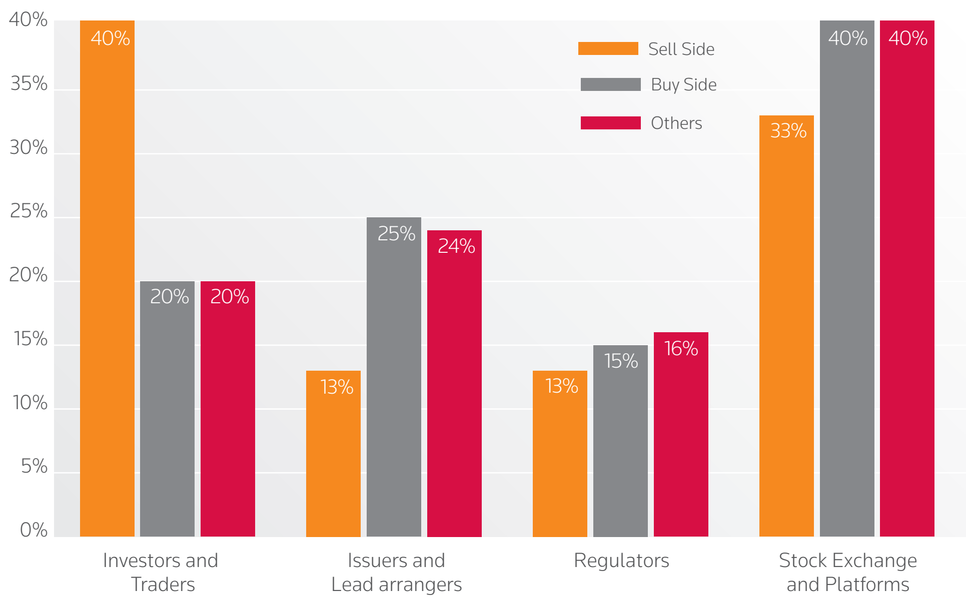
40% of investors and 40% of other key market players believe the stock exchanges and platforms are the main drivers for a more active secondary market. Accordingly, many stock exchanges and platforms should take serious steps to promote their local Islamic fixed income markets following the lead of countries such as Malaysia and Bahrain.

On the other side of the equation, 40% of issuers believe that investors and traders can activate the secondary market through trading their investments instead of holding them to maturity. 25% of investors agree issuers can improve the secondary market through selling sukuk to the right investor base, i.e. who would not choose to hold sukuk to maturity.

SURVEY FINDINGS – WHAT IS THE MAIN REASON FOR LOW LIQUIDITY AND TRADABILITY IN THE MARKET?



SURVEY FINDINGS – IN YOUR OPINION, WHOSE PARTICIPATION IN SECONDARY MARKETS WILL CHANGE SUKUK MARKET LIQUIDITY?



By Balance Sheet Sukuk Categorization

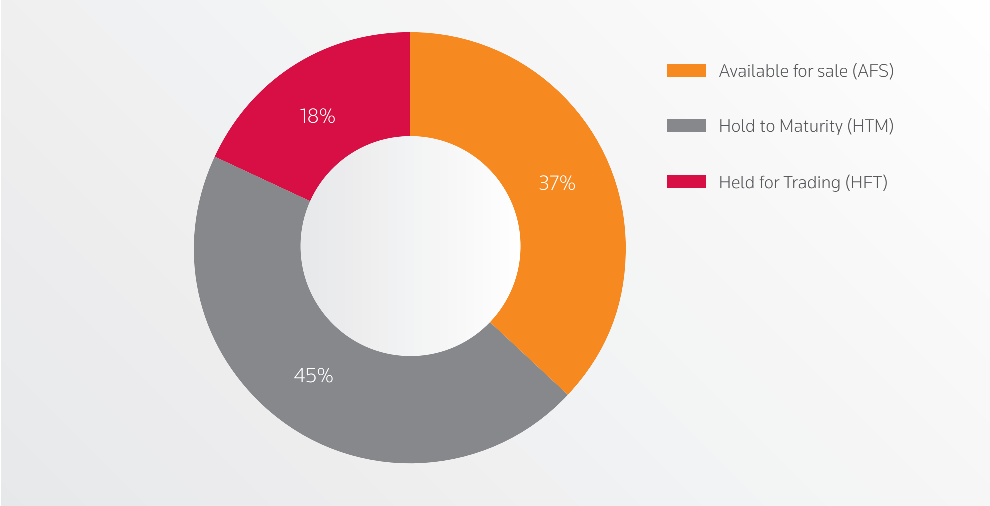
Tradability weakens as sukuk is further undersupplied

45% (last year: 43%) of investors would classify their investment in sukuk as hold to maturity (HTM). This is due to the scarcity of sukuk in the secondary market and excess funds held by Shariah-sensitive institutions. However, surprisingly, it is mostly the non Shariah investors who are holding sukuk as HTM. They usually hold onto these sukuk due to their strong credit and attractive rates.

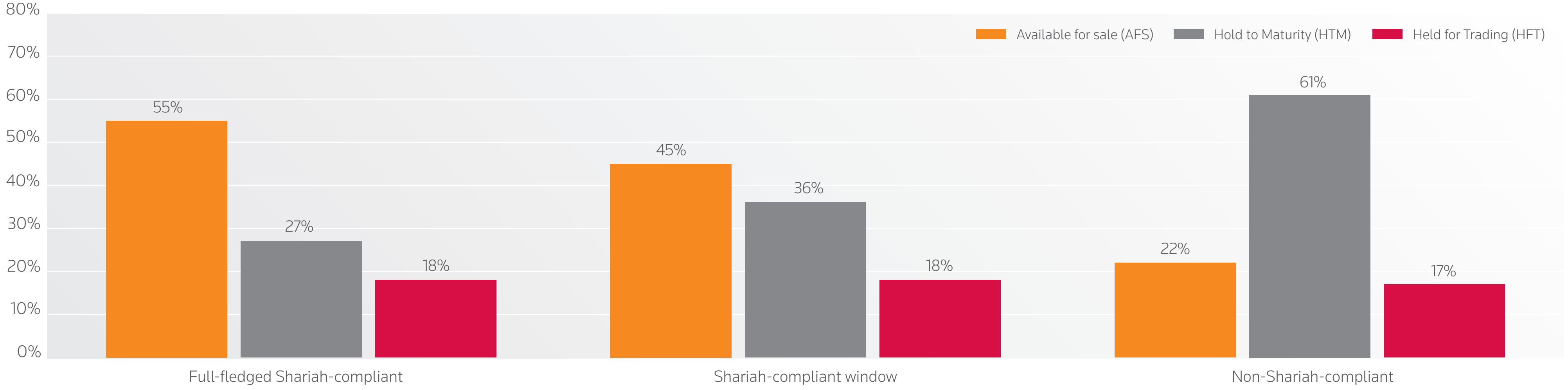
37% of investors classify their sukuk as available for sale (AFS) and only 18% as held for trading (HFT) as many investors face Shariah constraints when it comes to trading certain type of structures.

The undersupply of sukuk has forced many investors to hold on to their sukuk, hence limiting trading in secondary markets. The most liquid market today is Malaysia, which accounts for 50% of global sukuk, thanks to strong primary market issuance and secondary market infrastructure.

SURVEY FINDINGS – HOW DO YOU NORMALLY CATEGORIZE SUKUK IN YOUR BALANCE SHEET?



SURVEY BREAKDOWN – HOW DO YOU NORMALLY CATEGORIZE SUKUK IN YOUR BALANCE SHEET?



By Tenor

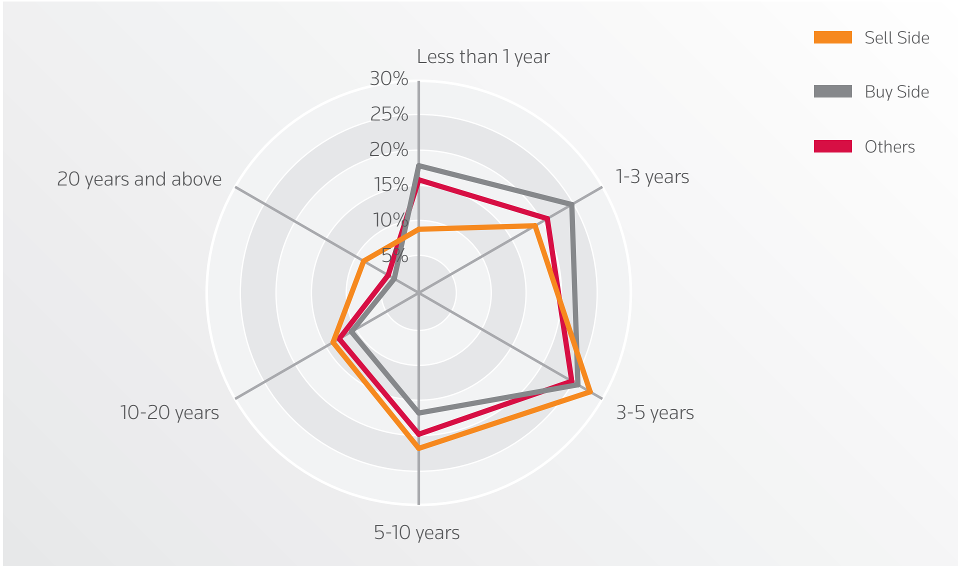
Issuers becoming more confident with sukuk, making them tap into longer maturity

Investors and lead arrangers show a strong preference for tenors of 3-5 years. The most preferred tenor is 3-5 years followed by 1-3 years; these tenors give investors the opportunity to better control their liquidity positions.

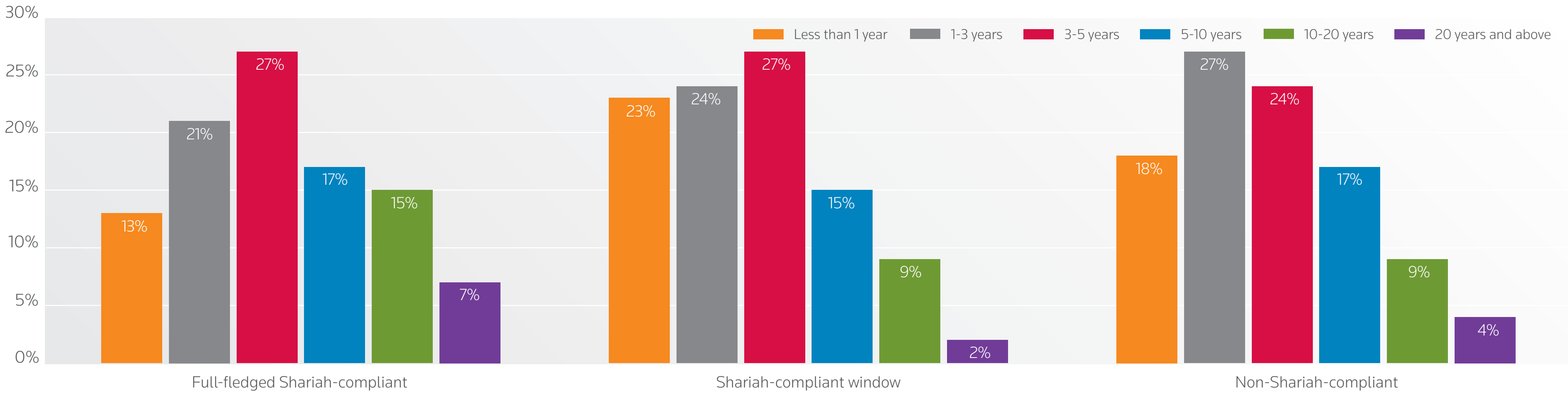
Lead arrangers and issuers prefer to issue sukuk of slightly longer tenors, with the most preferred being 3-5 years followed by 5-10 years as this will give them more flexibility in repaying investors.

The tenor is a strong indication that both issuers and investors are becoming comfortable with sukuk, and are locking their funds for longer terms. The sukuk in many countries (like Bahrain) started as a money market instrument that the central bank would issue with maturity of 90 days; these served the liquidity positions of banks. The sukuk market has now grown to be a more reliable source of funding for many governments and corporates.

SURVEY FINDINGS – TENOR PREFERENCE



SURVEY BREAKDOWN – TENOR PREFERENCE

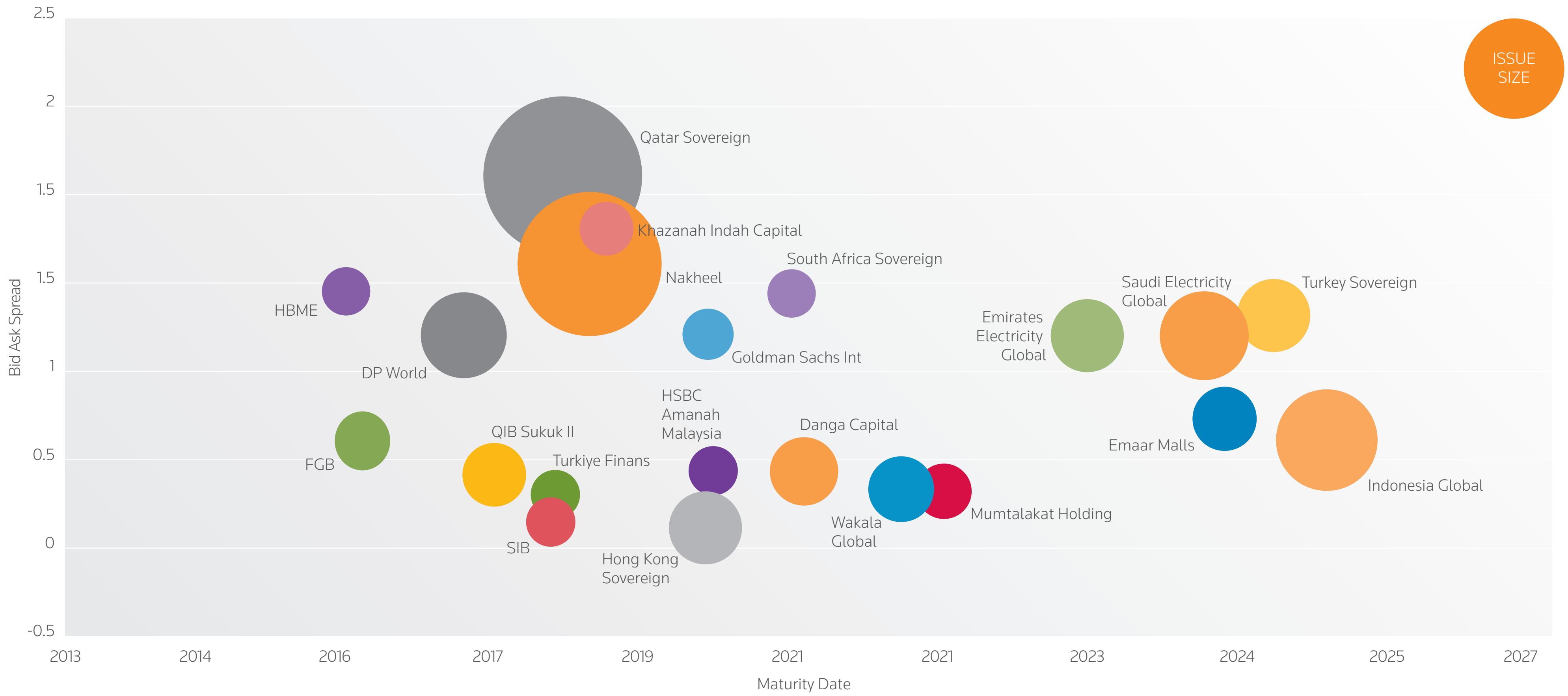


By sukuk bid-ask price spread

Bid & Ask Spreads are getting tighter as sukuk demand increases

As per Thomson Reuters Eikon data, bid-ask sukuk prices for international papers have tightened compared to previous years, reflecting healthier and more efficient fixed income markets particularly for blue chip corporates with longer maturities. This confirms our survey findings that reveal investors prefer longer tenors and stronger credits.

OUTSTANDING USD INTERNATIONAL SUKUK BID-ASK SPREAD OCTOBER 15TH, 2015 – ABOVE USD500 MILLION



IILM Sukuk

Survey participants believe IILM sukuk is a good substitute for conventional Level 1 HQLA

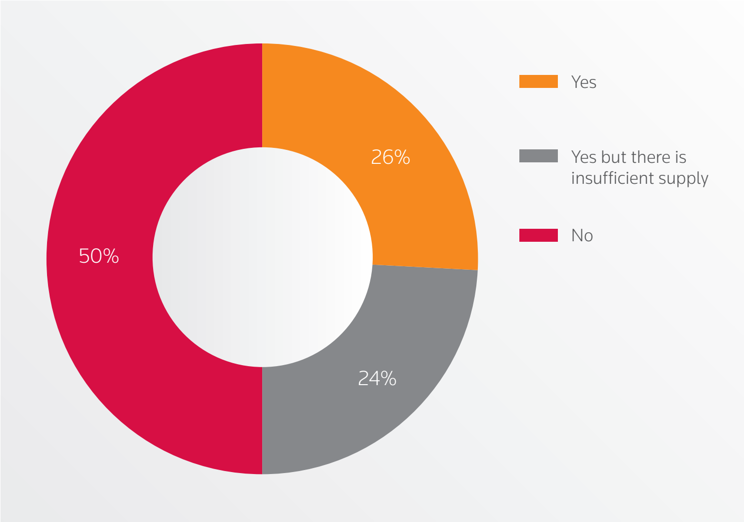
Half of all investors on our Sukuk Survey do not invest in IILM sukuk. This could send a signal that IILM should increase its outreach and volume to benefit a larger investor base. A total of 50% invest in IILM sukuk -- 24% of this group believe there is insufficient supply.

The clear majority of our survey participants view the IILM sukuk as a good substitute for conventional Level 1 HQLA. If the industry believes it is a Level 1 HQLA asset, they would want to have their own regulators classify it as Level 1 (i.e. equal treatment to deposits with the central bank or U.S. Treasuries). It will be important for the central banks to give this treatment and probably also make it repo eligible to deal with the less developed secondary markets that are required for a Level 1 asset.

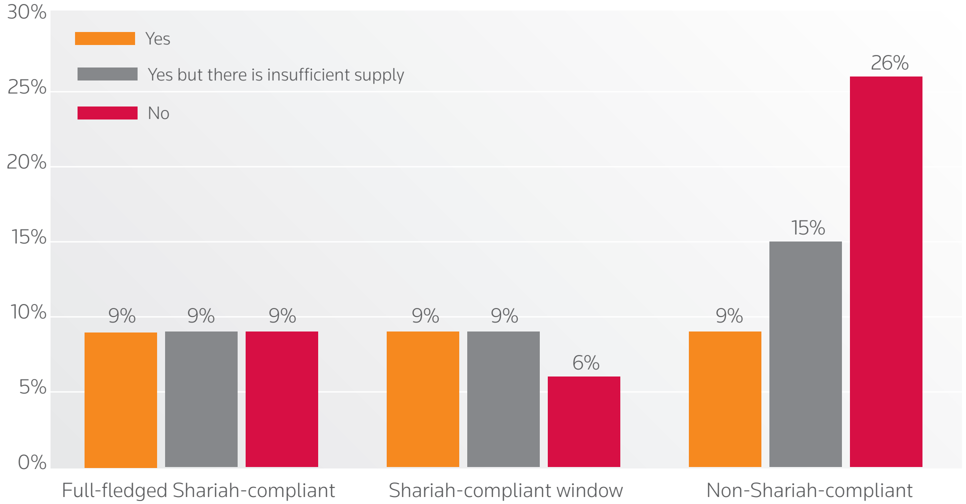
Interestingly, other key market players are in agreement that IILM sukuk should be classified as Level 1, which may reflect their desire for an 'upgrade' of their own sukuk. The classification of sukuk as HQLA is driven by both stability of value and depth of secondary market activity so if the IILM sukuk (which is some of the highest rated regular short-term papers in the market) are given Level 1 status despite only emerging liquidity then issuers may believe their own sukuk will get an 'upgrade' to be HQLA-eligible which will boost demand.

It is unclear what the respondents who said 'none of the above' think the treatment of IILM should be and whether it reflects concerns about the ability of IILM sukuk to develop sufficient liquidity to be HQLA-eligible without central bank support.

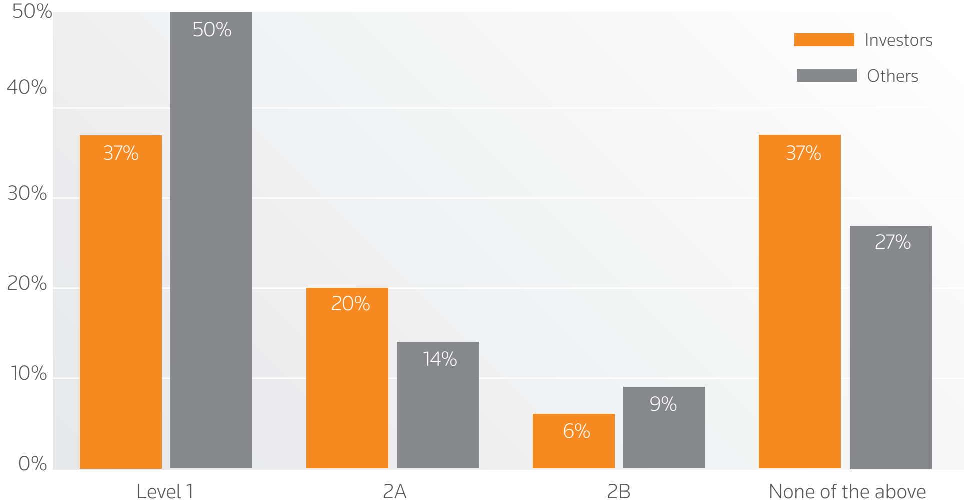
SURVEY FINDINGS – DO INSTITUTIONS LIKE YOURS INVEST IN THE IILM SUKUK?



SURVEY BREAKDOWN



SURVEY FINDINGS – DO YOU THINK REGULATORS SHOULD CLASSIFY IILM PAPER (FOR BASEL III HQLA REQUIREMENTS) AS



By Lead Arrangers Preference

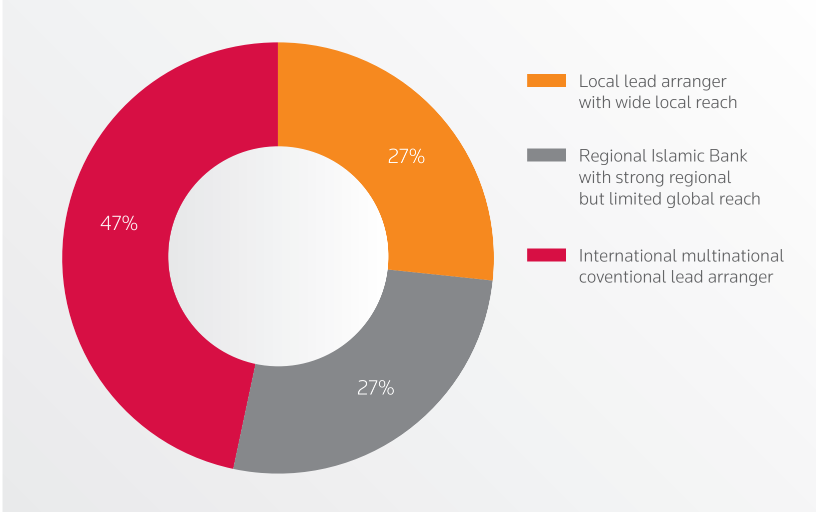
International lead arrangers are preferred given the wide acceptance of sukuk

47% of issuers would prefer International multinational conventional lead arrangers for their sukuk given their access to a wider investor base. Most issuers are looking to diversify their sources of funding outside their regular markets to widen their funding options.

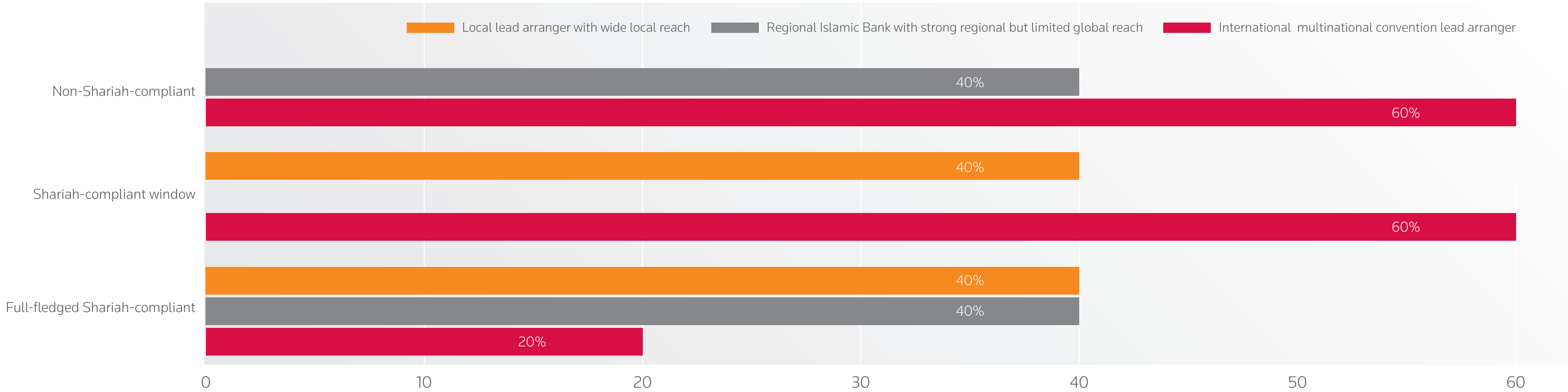
The remaining 53% are equally divided between local lead arrangers and regional Islamic banks with strong regional presence but limited global reach at 27% each. Given that most fully fledged Shariah-compliant financial institutions are small in size relative to conventional institutions, they usually look for regional investors which are familiar with their credit and would ask for lower returns.

It is understandable why survey participants choose international lead arrangers given the wide acceptance for sukuk. The vast majority of sukuk investors come from the Middle East and Europe, hence an international multinational conventional lead arranger would have better distribution channels compared to local or regional Islamic lead arrangers.

SURVEY FINDINGS – WHAT TYPE OF LEAD ARRANGER WOULD YOU PREFER?



SURVEY BREAKDOWN – WHAT TYPE OF LEAD ARRANGER WOULD YOU PREFER?



List of Lead Arrangers as of Nov 2, 2015

Book Runner	Arranging	Market Share	Number of Issues
HSBC Holdings PLC	2,067.1	14.1	12
Standard Chartered PLC	1,815.2	12.3	16
CIMB Group Sdn Bhd	1,651.1	11.2	6
Dubai Islamic Bank PJSC	1,266.4	8.6	10
National Bank of Abu Dhabi	1,181.4	8.0	10
JP Morgan	1,114.1	7.6	4
Citi	801.6	5.5	5
Al Hilal Islamic Bank	541.4	3.7	5
Emirates NBD PJSC	528.8	3.6	7
Noor Bank	312.2	2.1	4
Abu Dhabi Islamic Bank (ADIB)	276.5	1.9	3
Morgan Stanley	250.0	1.7	1
Bank of America Merrill Lynch	250.0	1.7	1
First Gulf Bank	249.7	1.7	3
Malayan Banking Bhd	206.4	1.4	3
QInvest LLC	187.5	1.3	2
Barwa Bank QSC	187.5	1.3	2
RHB	181.9	1.2	3
Natl Comml Bank Saudi Arabia	172.2	1.2	2

Book Runner	Arranging	Market Share	Number of Issues
Goldman Sachs & Co	150.0	1.0	2
National Bank of Sharjah	125.0	.9	1
Noor Islamic Bank	125.0	.9	1
Oversea-Chinese Banking	116.1	.8	1
NCB Capital Corp	111.1	.8	1
Gulf International Bank	111.1	.8	1
Natixis	111.1	.8	1
Bank of Sharjay PLC	103.9	.7	2
Banque Saudi Fransi	88.9	.6	1
GIB Capital	88.9	.6	1
Anoa Capital SA	66.7	.5	1
ADS Securities LLC	66.7	.5	1
Kuwait Finance House	62.5	.4	1
ANZ Banking Group	41.4	.3	1
Deutsche Bank	41.4	.3	1
Warba Bank	41.4	.3	1
BNP Paribas SA	20.0	.1	1
Subtotal with Book Runner	14,712.2	100.0	24

Source: Thomson Reuters Date: 02/11/2015

Sukuk Funds

Sukuk funds reached US$3.3 billion in September 2015, taking 5.9% of total Islamic funds outstanding

The share of sukuk funds outstanding reached its peak in 2012 at US$4.2 billion (commensurate with sukuk issuance at a high of US$137 billion in 2012). However, this share of sukuk funds outstanding has declined and is now stabilized between 6.3%-5.9% ever since.

In terms of sukuk funds launched, the share was at its highest in 2010 and declined significantly to just 11.9% or US$340 million in 2014 and 4.9% or US$ 86 million up to September 2015.

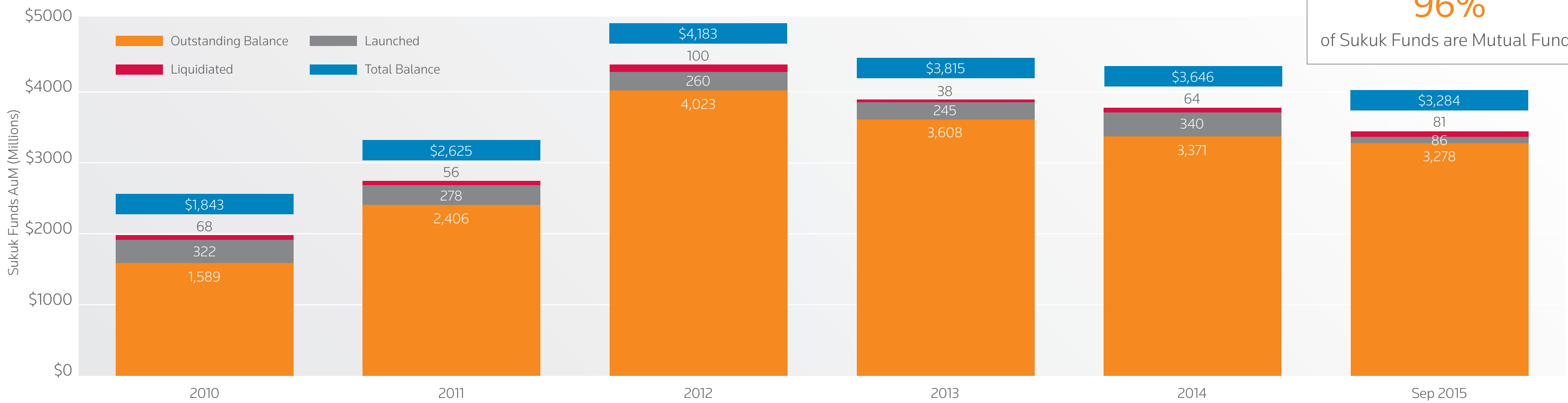
Despite declines in recent years, the growth rate of sukuk funds was and continues to be larger, almost 4 times faster in September 2015 when compared to the growth of total Islamic funds globally. Also, this growth is expected to be maintained in line with asset managers and investors expectations.

	2010	2011	2012	2013	2014	Sep 2015
Share of Total Islamic Funds AuM						
Outstanding	3.8%	5.5%	7.3%	6.3%	5.6%	5.9%
Launched	44.3%	30.9%	15.0%	16.7%	11.9%	4.9%
Number of Sukuk Funds						
Outstanding	94	103	111	140	164	170
Launched	25	14	15	35	28	13
Liquidated	5	5	7	6	4	7
Compound Annual Growth Rate (CAGR) from 2010						
Sukuk Funds	NA	19%	31%	20%	15%	13%
Islamic Funds	NA	0%	6%	6%	6%	3%

24% and **28%**

of asset managers and investors respectively would prefer to tap into sukuk in 2015 and 2016 (these numbers are higher than for other asset classes) according to Thomson Reuters Global Islamic Funds Preferences and Outlook Survey 2015.

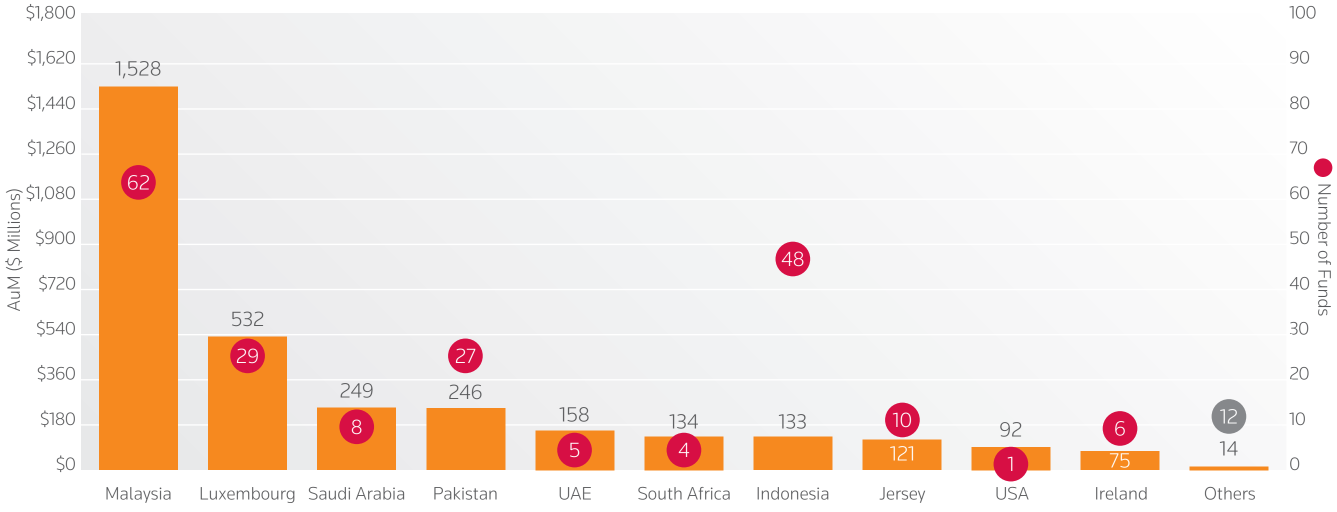
AUM OF GLOBAL SUKUK FUNDS OUTSTANDING



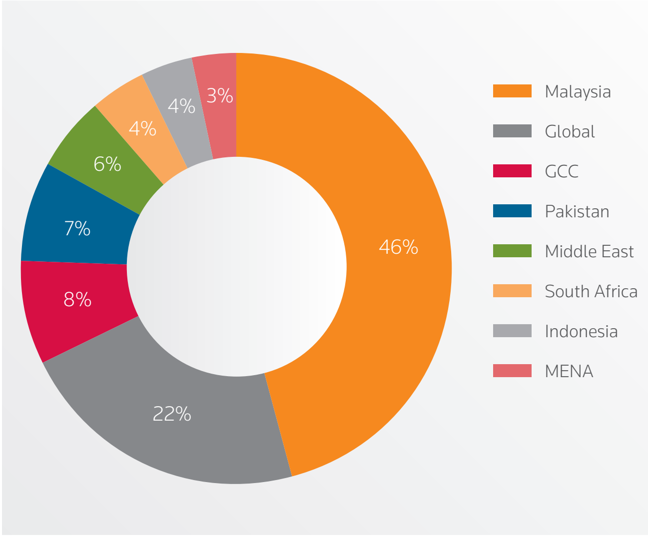
96%

of Sukuk Funds are Mutual Funds

OUTSTANDING ASSETS UNDER MANAGEMENT VS. NUMBER OF SUKUK FUNDS BY DOMICILE (BY SEP 2015)



SUKUK FUNDS AUM OUTSTANDING BY GEOGRAPHICAL FOCUS (BY SEP 2015)



By domicile and geographical focus, Malaysia dominates in terms of number and AuM of sukuk funds outstanding

As highlighted in the Thomson Reuters Global Asset Management Outlook 2015, Malaysia is the second largest domicile for total Islamic funds globally after Saudi Arabia when taking into consideration all asset classes. Also, since Malaysia is the largest market for sukuk issuances, it follows that Malaysia will dominate the sukuk funds market, accounting for 47% total sukuk funds in terms of domicile and similarly 46% in terms of geographical focus. Most of these funds are locally focused. For 2015, Malaysia only launched US$5 million in sukuk funds following Indonesian funds that focus locally and Luxembourg funds that focus globally.

Pakistan sukuk funds outperform other countries

However, the sukuk funds in Malaysia, Indonesia, and Luxembourg trail Pakistani funds on average cumulative performance (which measures the percentage growth of funds). Most Pakistani funds achieved growth in the range of 2% to 8% for the year between Q3 2014 and Q3 2015. This could be attributed to the continuous stable political environment and stable currency following the 2013 presidential elections and the push by the government to develop the Islamic finance industry. Sukuk volumes in Pakistan are also expected to increase mainly because of ramped up infrastructure spending as well the need to part-finance the state's budget.

Launched in 2015 by Domicile (Millions)	
Indonesia	$35
Luxembourg	$46
Malaysia	$5
Pakistan	$1

Launched in 2015 by Geographical Focus (Millions)	
Global	$46
Indonesia	$35
Malaysia	$5
Pakistan	$1

Best Cumulative Performance (%) by Geographical Focus (Sep '14 - Sep '15)	
Pakistan	3.54
GCC	1.89
Middle East	0.38


REUTERS/Yuya Shino

Chapter Six

Survey Methodology

REUTERS/Thomas Peter

Survey Methodology

Population and Sampling

The Sukuk Forecast and Perceptions Survey 2016 consists of three separate groups of participants: lead arrangers/issuers, investors/traders, and other key market players such as central banks, regulators, legal advisors, and credit rating agencies.

LEAD ARRANGERS

In collating the population of lead arrangers, level of activity in the sukuk market was the major consideration. A total population of 50 lead arrangers was targeted based on the sukuk league table as compiled by the Zawya Sukuk Monitor, in addition to Thomson Reuters data.

The 50 arrangers were selectively chosen as a target population to represent not only the regular arrangers who usually arrange 5 to 7 international sukuk per year, but also to represent a wider range of arrangers that are continuously involved in arranging local currency issuances. This ensures a more representative sample.

INVESTORS

In determining the target population of investors their level of activity was considered. We chose investors across the full spectrum of sectors, with activity in sukuk investment within the last 2 years.

A target population of 200 investment firms and investor representatives was extracted from Zawya Sukuk Monitor.

OTHER KEY MARKET PLAYERS

In collecting the population of other key market players, level of involvement in the sukuk market was considered whether as regulators, legal and Shariah advisors or credit rating agencies.

A target population of 100 other key market players was extracted from Zawya Sukuk Monitor.

Returned responses for arrangers, investors and other key market players include data that some would consider being proprietary information related to the objectives of the institutions represented by respondents. The survey has also elicited responses that reveal methods of analysis and perceptions of sukuk characteristics that are expected to influence demand and supply in the market.

The response rates for both lead arrangers/issuers, investors/traders and other key market players are sufficiently significant for this exercise. We believe that the respondents' perceptions and forecasts about sukuk have provided an indicative and representative cross sample of the sukuk industry as a whole.

DATA COLLECTION AND SURVEY PERIOD

The participants were first contacted via telephone to request their participation in the survey prior to sending invitations via email. Email invitations for the survey were sent on Jun 22, 2015 and reminders were sent to non-respondents on Aug 5, 2014. The survey was closed at 1600 GMT on Sep 8, 2014.

SURVEY QUESTIONS

3 types of questions were presented to the target population – multiple choice questions, ranking questions, and open-ended questions.

For ranking questions, the data was analyzed such that 8 points were awarded to the first choice, 7 points to the second, s6ix points to the third and so on. The weighted average results are represented in the charts.

Ex-post Analysis

Response Statistics

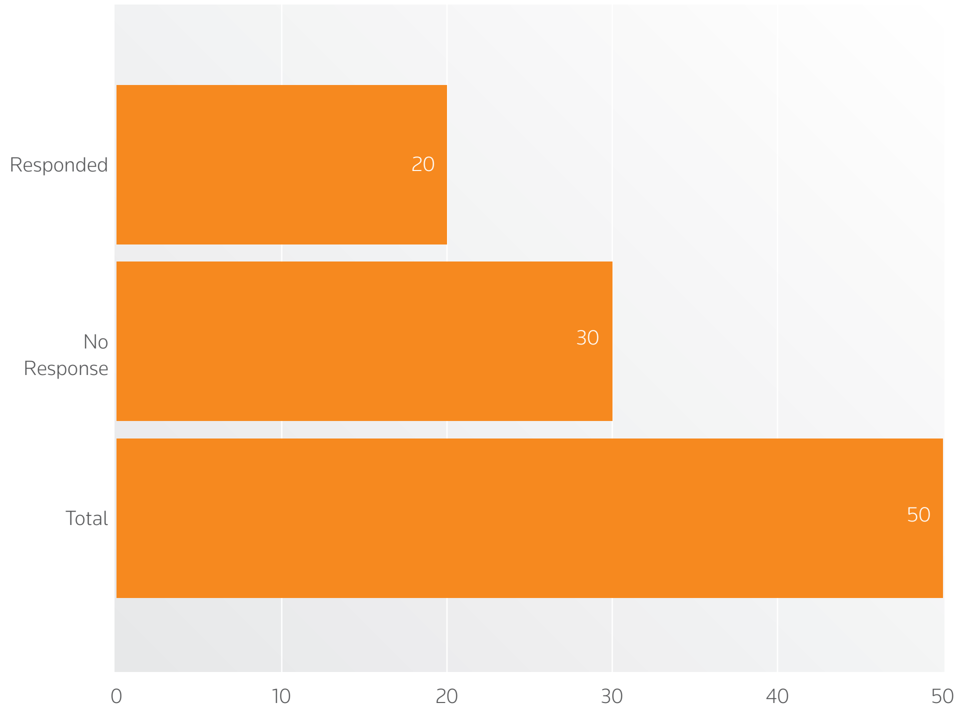
SELL SIDE

The arranger population of 50 was comprised of international banks, local banks, and asset management firms. A total of 20 responses were received, with 30 non-respondents.

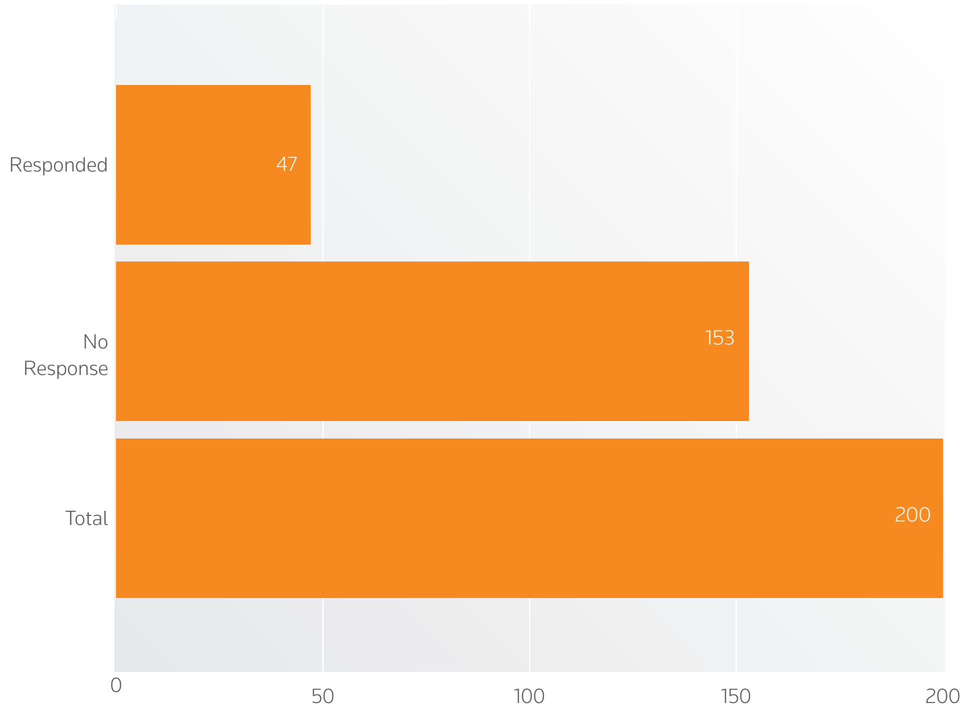
BUY SIDE

The investor population of 200 comprised international and local investors/investor representatives. A total of 47 responses were received, with 195 non-respondents.

SELL SIDE: LEAD ARRANGERS ALLOCATION AND RESPONSE RATE



BUY SIDE: INVESTORS ALLOCATION AND RESPONSE RATE



Sector Distribution

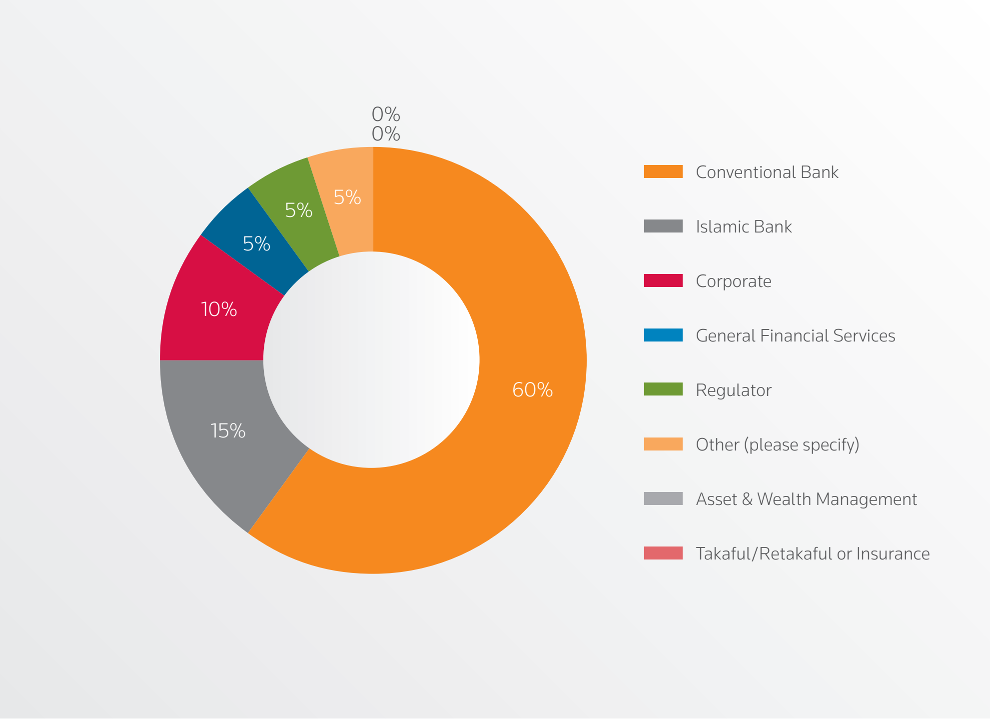
SELL SIDE

By sector distribution, conventional banks take the lead on 60% out of which 75% of them are Shariah-compliant windows, followed by Islamic banks on 15%.

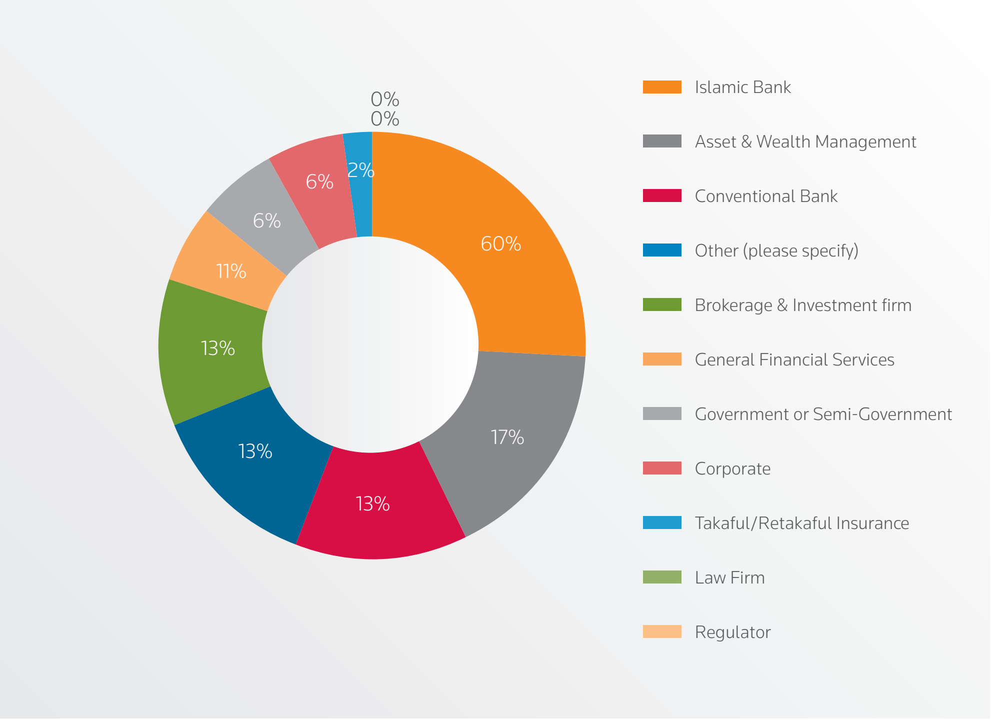
BUY SIDE

On the buy side, demand for sukuk is represented by a broad range of sectors and segments, with Islamic banks ranking highest at 26%, followed by Asset & Wealth Management at 10%.

SELL SIDE: BY SECTOR



BUY SIDE: BY SECTOR



Type of Institutions

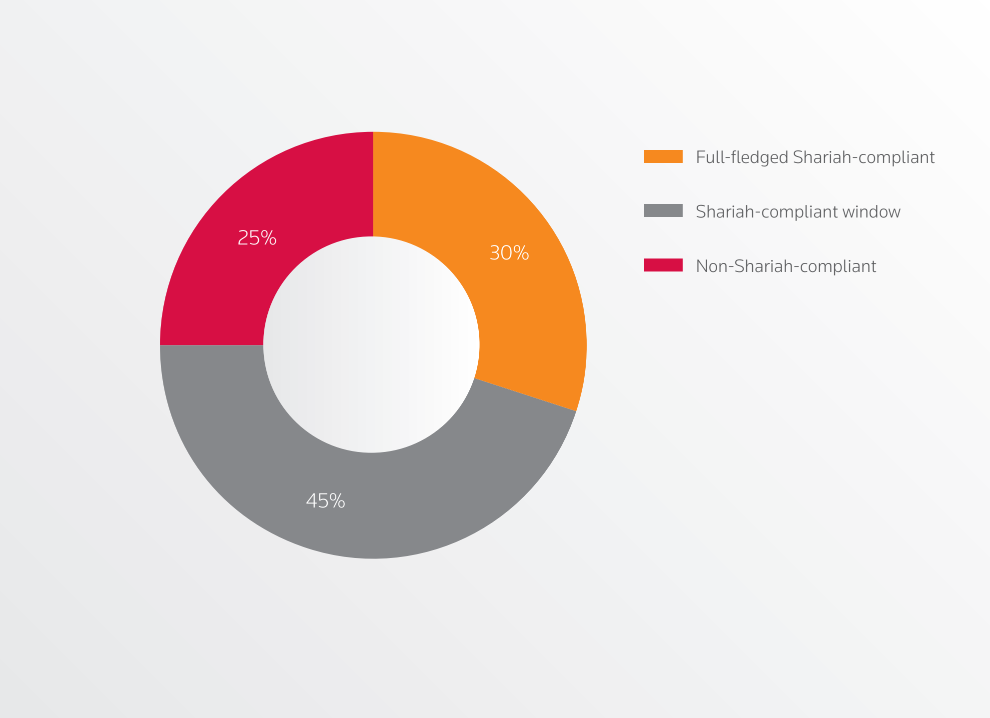
SELL SIDE

45% of the lead arrangers are from Shariah-compliant windows are financial institutions, followed by 30% from full fledged Shariah-compliant and 25% from non-Shariah-compliant institutions.

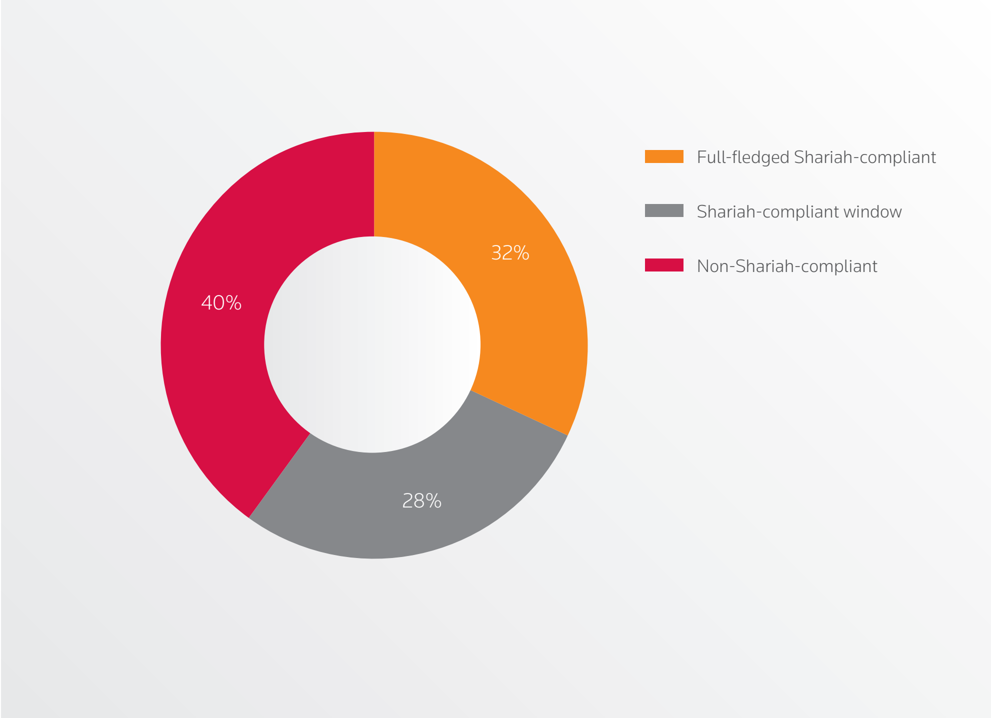
BUY SIDE

In contrast, the majority of responses of investors came from non-Shariah-compliant 40% followed by 32% from full fledged Shariah-compliant windows and 28% from Shariah-compliant institutions

SELL SIDE: TYPE OF INSTITUTIONS



BUY SIDE: BY SECTOR



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