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# Islamic Finance Outlook 2010





## CONTENTS

<b>FOREWORD</b>	
by Paul Coughlin, Executive Managing Director, Standard & Poor's	Page 5
<b>RATINGS LIST</b>	
Islamic Issues & Issuers Rated By Standard & Poor's	Page 7
<b>PUBLISHED ARTICLES</b>	
Islamic Finance Is Likely To Advance In 2010 On Firm Growth And Widening Geographic Reach	Page 9
The Sukuk Market Is Likely To Show Steady Growth In 2010	Page 13
Islamic Banking Has Reached Critical Mass In The Gulf After Sustained Growth, And Expansion Is Set To Continue	Page 19
GE Capital Sukuk Ltd.'s Trust Certificates	Page 29
European Finance House Offshore Sharia Fund Assigned 'AAf/S1+' Fund Credit Quality And Volatility Ratings	Page 35
Using Fund Ratings As A Tool To Assess Credit And Market Risks In Sharia Funds	Page 37
Analyzing Sharia-Compliant Takaful Insurance And Reinsurance Companies: Concepts And Considerations	Page 43
S&P Announcement: Standard & Poor's Voted Best Takaful Ratings Agency	Page 49
Dubai Islamic Bank	Page 51
<b>GLOSSARY</b>	
Glossary of Islamic Finance Terms	Page 61
<b>CONTACTS</b>	
Who to contact at Standard & Poor's	Page 64



## FOREWORD

The global growth of Islamic finance stayed strong in 2009, just when the majority of the world's financial systems found themselves deleveraging amid the capital market dislocation and its spread to economies around the world. Assets of the top 500 Islamic banks expanded 28.6% to \$822 billion at year-end 2009. Standard & Poor's estimates that Sharia-compliant assets currently total about \$1 trillion worldwide, after brisk growth during the past decade. With this advance, we believe Islamic finance has become a recognized and a specific segment of finance on its own with bright growth prospects.

Last year saw major trends in Islamic finance. Asian countries cemented their lead in sukuk issuance. Moreover, interest in this prosperous compartment of the global debt market, from numerous countries and financial institutions around the globe, has intensified. The year also saw the creation of new Islamic banks, particularly in Europe and Africa.

At the same time, 2009 ushered in a new set of challenges; solutions, as they take shape, will in our opinion define the future of the industry. Among the main questions associated with the expansion of Islamic finance are the size of demand for Sharia compliant products in non Muslim countries, regulatory and tax environments, the support of the political and financial communities, sovereign sukuk issuance, the scarcity of qualified human resources in the sector, discussion on the framework for Sharia compliance, and the resolution of sukuk defaults.

Standard & Poor's has continued to serve market participants in Islamic finance with its independent and objective credit opinions. At the same time, Standard & Poor's extended its coverage to Sharia-compliant funds, applying its existing set of criteria applicable to rate fixed-income funds to cater to the needs of market participants. In 2010, we also rated for the first time a Sharia-compliant fund originated by European Finance House, a U.K.-based subsidiary of Qatar Islamic Bank. Standard & Poor's remains dedicated to serving Islamic finance and investors through our credit ratings, and tailored products, such as our stability ratings for Islamic financial institutions offering profit sharing investment accounts, or our Sharia equity indices.

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



**Paul Coughlin**

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# Islamic Issues & Issuers

## Rated By Standard & Poor's May 11, 2010

ISSUE CREDIT RATINGS			
Originator	Issue amount (mil. \$)	Long-term foreign currency rating	
1	Central Bank of Bahrain Sukuk	\$995 (Various)	A
2	DIB Sukuk Co. Ltd.	\$750 million	BBB-
3	DP World Sukuk Ltd. (DP World)	\$1.5 billion	BB
4	Dubai Sukuk Centre Ltd.	\$1.25 billion	B+
5	EMAAR Sukuk Ltd. (Emaar Properties PJSC)	\$2 billion	BB
6	GE Capital Sukuk Ltd	\$500 million	AA+
7	GFH Sukuk Ltd. (Gulf Finance House)	\$200 million	CCC-
8	IDB Trust Services Ltd. (Islamic Development Bank)	\$1.5 billion	AAA
9	JAFZ Sukuk Ltd.	AED7.5 billion	B+
10	Loehmann's Capital Corp. (Loehmann's Holdings Inc.)	\$110 million	C
11	MBB Sukuk Inc.	\$300 million	BBB+
12	Perusahaan Penerbit SBSN Indonesia I	\$650 million	BB
13	PETRONAS Global Sukuk Ltd.	\$1500 million	A-
14	Qatar Global Sukuk QSC	\$700 million	AA-
15	RAK Capital (Emirates of Ras Al Khaimah)	\$2 billion	A
16	Saudi Basic Industries Corp.	SAR16 billion	A+
17	Sharjah Islamic Bank Sukuk	255	BBB
18	Sukuk Funding (No.2) Ltd. (Aldar Properties PJSC)	AED3.8 billion	A-
19	Sun Finance Ltd. (Sorouh Abu Dhabi Real Estate LLC)	AED4 billion	A/BBB+/BBB-
20	Tadamun Services Berhad (Islamic Development Bank)	MYR1 billion	AAA

ISSUER CREDIT RATINGS			
Issuer	Country	Long-term foreign currency rating	
1	Albaraka Banking Group (B.S.C.)	Bahrain	BBB-/Stable/A-3
2	Al Rajhi Bank	Saudi Arabia	A/Stable/A-1
3	BEST RE	Tunisia	BBB+/Stable/--
4	Dubai Islamic Bank	United Arab Emirates	BBB-/Negative/A-3
5	Dubai Islamic Insurance & Reinsurance Co. (Aman)	United Arab Emirates	BBB/Negative/--
6	Gulf Finance House	Bahrain	CCC-/Negative/C
7	Hannover ReTakaful B.S.C.	Bahrain	A/Stable/--
8	First Takaful Insurance Co.	Kuwait	BBB-/Stable/--
9	Islamic Development Bank	Saudi Arabia	AAA/Stable/A-1+
10	Kuwait Finance House	Kuwait	A-/Negative/A-2
11	Salama/Islamic Arab Insurance Co. (P.S.C.)	United Arab Emirates	BBB+/Stable/--
12	Sharjah Islamic Bank	United Arab Emirates	BBB/Stable/A-2
13	Takaful International Co. BSC	Bahrain	BBB/Stable/--
14	Takaful Re Ltd.	United Arab Emirates	BBB/Stable/--
15	Wethaq Takaful Insurance Co. K.S.C. (Closed)	Kuwait	BB/Negative/--

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



# Islamic Finance Is Likely To Advance In 2010 On Firm Growth And Widening Geographic Reach

Standard & Poor's Ratings Services considers that growth of Islamic finance stayed strong in 2009, just when many of the world's financial systems found themselves deleveraging amid the capital market dislocation and its spread to economies around the globe. Assets of the top 500 Islamic banks expanded 28.6% to total \$822 billion in 2009, compared with \$639 billion in 2008, according to publicly available information.

We continue to believe a bright outlook is likely worldwide for Islamic finance in 2010, on the back of steady growth and geographic diversification. In our view, Islamic finance is poised to make further inroads in developed Western markets while Southeast Asian countries will likely fuel the Islamic finance advance in Asia during the coming year.

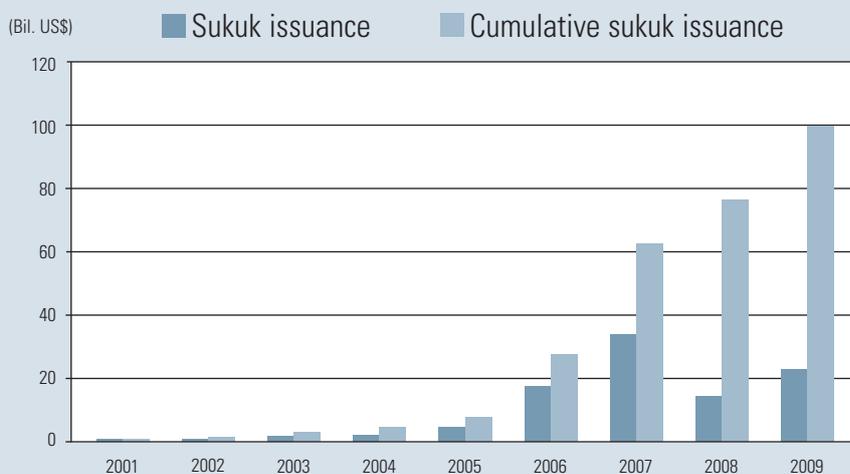
At the same time, though, we believe there are a number of important questions for which the answers are not necessarily yet clear but that may play a part in shaping the sector's future growth.

Specifically in non-Muslim countries, and especially in Europe, we consider they include the size of demand for Sharia-compliant products, regulatory and tax environments, the support of the political and financial communities, sovereign sukuk issuance, and the possibility of a common strategy for extending Islamic finance across EU countries.

## The Near-Term Sukuk Pipeline Looks Pretty Plump

Issuance of Sharia-compliant sukuk notes currently accounts for about 10% of the global Islamic finance industry, following fast growth over the past decade. Cumulative total issues topped the symbolic mark of \$100 billion at year-end 2009, compared with less than \$500 million at year-end 2001. In our view, the market is slowly reviving after a major slowdown in 2008. Sukuk issues totaling \$23.3 billion in 2009 clearly outpaced the \$14.9 billion registered in 2008 and regained some ground against record issues of \$34.3 billion in 2007, according to our calculations (see chart 1).

Chart 1: SUKUK ISSUANCE (2001-2009)



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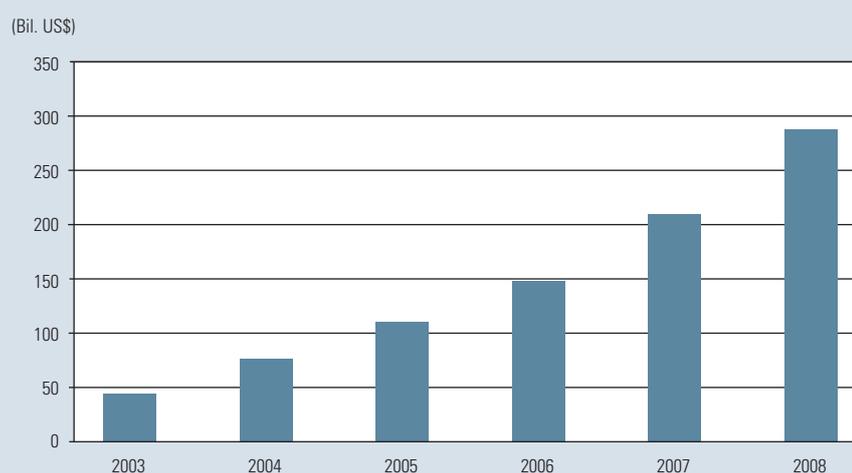
We believe that medium-term growth prospects for the world sukuk market are good. The pipeline is sizable and we have noted that interest from issuers in both Muslim and non-Muslim countries is increasing. In our view, Asia confirmed itself in 2009 as the major locomotive for sukuk market growth. During the year, 63.9% of global issuance occurred in Asian countries. Malaysia led the pack, serving as the host country to 54.1% of the region's issuers.

The year 2009 also witnessed a couple of defaults in the sukuk market, namely the sukuk issued by Saad Group and The Investment Dar Co. K.S.C.C. These reminded all those involved in the market that defaults can and do happen in Islamic finance. We believe that they are also shedding light on the possible consequences of defaults for creditors--ranging from recovery perspectives to access to underlying assets for investors.

### Rapid Growth Is Likely To Continue As The Economic Slowdown Recedes

Overall, many Islamic financial institutions appear to have been insulated from the global financial crisis, which is likely to be attributable, in our view, to Islamic finance principles prohibiting interest. This is the reason why Islamic banks didn't invest in structured products and so haven't suffered from the fall in some of these instruments' values. Total assets at Islamic financial institutions in Gulf Cooperation Council (GCC) countries grew continuously between 2003 and 2008, representing \$288.2 billion at year-end 2008 (see chart 2). The knock-on effects of the current economic slowdown have, however, pressured some Islamic financial institutions, in our view, as they have their conventional counterparts. We consider that the deepening economic recession in many countries, scarce liquidity, pronounced stock market declines, and plummeting real estate prices in some countries have hit the profitability of Islamic banks, especially in GCC countries. Some of the negative rating actions that Standard & Poor's has taken on some Islamic banks over the past 18 months reflect our view of the impact of these adverse changes.

Chart 2: TOTAL ASSETS OF ISLAMIC BANKS IN THE GCC REGION



GCC--Gulf Cooperation Council countries: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. Source: Standard & Poor's  
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As most economies begin pulling out of the downturn, we expect Islamic finance to continue its rapid growth. We estimate that Sharia-compliant assets worldwide currently total about \$1 trillion after brisk growth during the past decade. With this expansion, we believe Islamic finance has become a recognized and a specific segment of finance on its own with still-bright growth prospects.

## **We See External Factors Shaping Growth In Non-Muslim Countries, Especially Europe...**

We note that interest in this compartment of global finance appears to be increasing in nontraditional centers of Islamic finance. For instance, following in the U.K.'s footsteps, France is progressively introducing Islamic finance into its financial system. The sector remains in the embryonic stages within the French financial system, for the time being, but we believe the prospects are positive mainly as a result of some political stakeholders' support. Several other European countries, such as Italy and Malta, appear to be showing interest by organizing events to gain expertise in this field; we understand they are also considering whether it is possible to implement an Islamic finance offer in their respective domestic markets. We have noted that some Asian and African countries are also striving to develop Islamic finance by establishing Islamic banks or by joining the league of countries issuing sukuk.

Still, major questions about Islamic finance's future growth and broadened geographic reach in our view remain unanswered at this stage. We see various factors setting the pace of Islamic finance growth in non-Muslim countries and particularly in Europe.

- The size of demand for Sharia-compliant products and whether or not the market can achieve critical mass is, in our view, uncertain. Visibility is lacking on how Muslim customers are interested in an Islamic banking offering and whether the principles of Islamic finance will attract non-Muslim customers.
- We believe that the regulatory environment for Islamic finance and the need to ensure the same treatment for Islamic and conventional banks from a regulatory and tax perspective are necessary pillars in building the foundation for Islamic finance development outside of its countries of origin. For instance, the British and French regulators are deploying efforts to make their tax and regulatory frameworks more attractive to Islamic financial institutions.
- Gaining the support of different stakeholders, especially in the political and business communities, is likely to be among the critical factors in our view. In the U.K., we have seen major conventional financial institutions playing what we believe is an instrumental role in developing the local Islamic finance offering. We believe that it is likely that replicating this strategy in other European countries that plan to extend their own local offerings would accelerate growth.
- European sovereign sukuk issuance, currently lacking, could help to construct a remuneration curve against which private sector issuers could benchmark themselves in our view. Several governments of non-Muslim countries--in particular the U.K.--have announced plans to issue sukuk in the past, but issues have yet to materialize.
- Whether or not the EU will forge a common strategy for Islamic finance development in Europe is an open question.

## **...Alongside Inherent Features Of Islamic Finance**

We also foresee hurdles specific to Islamic finance:

- The differing interpretations of Sharia law appear to have resulted in the fragmentation and lack of integration of the market for Islamic financial products. Standardization could help cut the costs of Islamic products and increase their attractiveness. It could also foster the emergence of a truly integrated global market for some Islamic finance products, in our view.
- Islamic financial institutions typically lack the necessary instruments for liquidity management.

- The sukuk market's small size and limited liquidity is a challenge in the context of assessing the possibility of future growth. However, we have observed that many major stakeholders are moving to create new markets for listing sukuk or enabling their listing in global markets. Transforming the sukuk market from an over-the-counter market to a more global and liquid market will in our view take time.
- Generally, human resources and expertise in Islamic finance are somewhat scarce. Our perception is that bankers and financiers with conventional expertise and backgrounds have brought the sector forward so far. To expand knowledge of Islamic finance, major European business schools are launching tailored training and degree programs.

### **The West May Be An Opportunity For Islamic Finance And Islamic Finance May Be An Opportunity For The West**

We have observed numerous big Western banks participating actively in developing modern Islamic finance since its inception. They have also tended to be major contributors to innovation in this field. As long as the potential client base is there, we expect their role in broadening Islamic finance to remain important given their stated business interests in developing customized solutions for clients. For instance, major global banks and law firms have participated in the structuring and offering of a large number of sukuk issued so far. In addition, we consider that access to Western economies may mean that Islamic financial institutions gain entry into large and diversified economies with a wide array of asset classes for investment, and in the case of most developed countries, strong legal frameworks.

The West may benefit in our view to the extent that Islamic finance opens up new potential markets for banking services. By developing a tailored financial offering, Western markets could achieve a dual objective:

- Islamic finance could improve the access to banking services for some Muslim customers that are avoiding conventional banks because they are not compliant with their beliefs.
- Western financial institutions would be able to access a compartment of investors that are looking only to invest in Sharia-compliant transactions by offering Sharia-compliant products.

We believe that Islamic finance investments may emerge gradually in the medium term in Western countries, starting probably with a wholesale offering that mainly aims to attract foreign direct investments in eligible sectors, or through raising money on the sukuk market. Examples of this include Bahrain-based Arcapita Bank's (not rated) acquisitions of France-based Compagnie Européenne de Prestation Logistiques (CEPL, not rated) and Irish energy company Virdian Group (not rated), alongside the General Electric Capital Corp. (AA+/Stable/A-1+) and World Bank sukuk issues in November 2009 and October 2009, respectively. In the longer run, we believe that a retail offering could take shape in some Western countries with large Muslim populations, such as France, the Netherlands, and Belgium, among others.

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

# The Sukuk Market Is Likely To Show Steady Growth In 2010

Standard & Poor's believes that medium-term growth prospects for the world's sukuk market are good. We foresee stable growth in issuance of these securities in 2010, after a recovery last year to issuance of \$23.3 billion. Notable developments in 2009 were:

- Cumulative issuance outstanding topped the symbolic bar of \$100 billion.
- Malaysia became the No. 1 issuing country with 54.1% of the value of sukuk issued.
- The dollar made a partial comeback but local currencies were the denomination of choice for sukuk issuance.
- Big new players tapped the market like General Electric Capital Corp. and International Finance Corporation.
- Two sukuk defaulted and one other avoided default with a last-minute support package and repayment.

The 2010 pipeline remains healthy, in our view, with about \$20 billion of sukuk publicly announced in the past that is likely to come to market if conditions permit. In addition, we understand from unofficial market sources that about \$10 billion more could potentially enter the pipeline. If that comes to market, total sukuk issuance in 2010 could approach the current 2007 record of \$34.3 billion.

The main uncertainty this year is market conditions. The default of two sukuk has raised questions about this relatively young market. These sukuk were issued by The Investment Dar Co. K.S.C.C. (TID) and Saad Group. A third sukuk issued by Nakheel PJSC avoided default thanks to a last-minute support package. We believe that once investors have a clearer view of the possible outcome of the two recent defaults, the sukuk market is likely to grow more strongly, perhaps after making some adjustments reflecting lessons learned. Beyond 2010, a major impediment to the emergence of an integrated, global sukuk market remains, in our view, lack of standardization, especially regarding Sharia compliance and the legal environment.

Standard & Poor's provides market participants with independent and objective opinions about the creditworthiness of issuers and issues--including those involving sukuk. We don't comment on the Sharia compliance of a particular issue or issuer. Our ratings don't constitute a recommendation to sell, buy, or hold a particular security, regardless of whether it is Sharia-compliant. Instead, our ratings may assist investors to make decisions and issuers to benchmark our view of their creditworthiness against their peers'.

Standard & Poor's rates 26 sukuk. The two recent defaults have not lead us to change our methodology for rating sukuk. That's because our ratings on sukuk refer to the relative credit risk or relative risk of default of the issue and do not factor in an analysis of recovery prospects postdefault. From an investor's point of view, however, major questions remain about the treatment of sukuk holders and recovery in the event of default.

We expect Malaysia to continue to lead the global sukuk market in issuance and foresee steady growth in the broader market in Southeast Asia over the next couple of years. Malaysia's well-established Islamic banking system, strong regulatory framework, and government support for Islamic finance enabled the country to take the lead in sukuk issuance in 2009. We believe the prospects are weaker for Dubai-based issuers and potentially other countries in the Gulf because investors are likely to have a low risk appetite and ask for a higher return to reflect the higher risks that they perceive.

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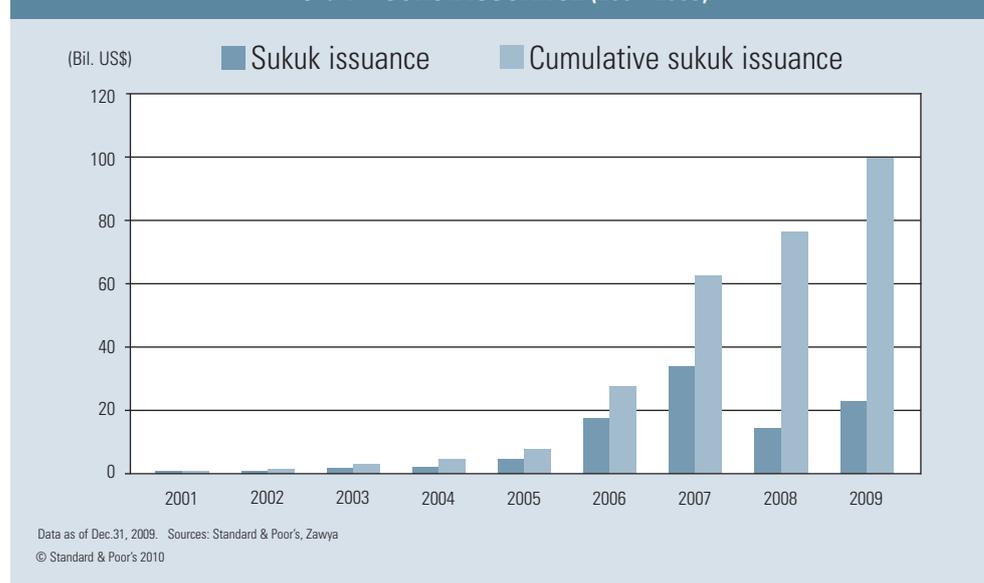
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### The Market Staged A Partial Recovery In 2009 Despite Difficult Conditions

The sukuk market partly recovered in 2009 with total issuance topping \$23.3 billion, propelling cumulative total issuance to the symbolic bar of \$100 billion (see chart 1). However, the pace of issuance remains below the 2007 record, when issuance reached \$34.3 billion. The market saw fewer issues in 2009: 140 compared with 160 in 2008, but the average size increased to \$170.1 million in 2009 from \$93.1 million in 2008. The lower amount of 2009 issuance than in 2007 was largely due to market conditions that remained difficult throughout the year and only moderate issuance from the United Arab Emirates, which in previous years had been a locomotive of the market. In addition, in late 2009, the market was concerned by the uncertainty regarding the Nakheel sukuk that matured on Dec. 14, 2009. The sukuk was repaid, thanks to a last-minute support package for Dubai from its oil-rich neighbor, Abu Dhabi.

Chart 1: **SUKUK ISSUANCE (2001-2009)**



The pipeline for sukuk issuance remains important in our view, and the market continues to attract interest from an increasing number of issuers in both Muslim and non-Muslim countries. Issuers have publicly announced about \$20 billion in sukuk that is likely to come to market if conditions permit. We understand from unofficial market sources that a potential \$10 billion more could come to market but this information remains to be confirmed.

### Greater Standardization And Liquidity Are Keys To The Emergence Of A Mature, Global Sukuk Market

The market for sukuk has reached critical mass, in our opinion, but is still relatively young and experiencing some growing pains. In our view, the emergence of an integrated global sukuk market would be facilitated by greater standardization, especially when it comes to Sharia interpretation and the regulatory framework. As steady growth of the Malaysian sukuk market has demonstrated, well-coordinated, coherent policy and a supportive regulatory framework can help Islamic finance grow. As a recent example, the Malaysian state granted legal status to the Malaysian National Sharia Advisory Council of Bank Negara Malaysia (the central bank of Malaysia) as the final arbiter in the country on matters related to the Sharia compliance of Islamic products. This move is set to facilitate consistent nationwide application of Sharia in Islamic financial matters. We believe the global Islamic markets could benefit from such consistency and clarity. One development in

this regard is the announcement by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) that it will screen products for Sharia compliance. We acknowledge that standardization is a complex task, given the need to accommodate interests of many countries.

Another hurdle, in our view, is relatively low liquidity in the secondary market. One development, that will only partly help to resolve this issue in Saudi Arabia, is the creation of a sukuk and bond market division by Saudi Arabia's Tadawul stock exchange. In addition, we note that issuers have the possibility of listing sukuk on more developed financial markets such as Euronext and the London Stock Exchange. Ultimately, liquidity is largely influenced by the size of a market and the sukuk market remains small.

### **Sukuk Is Facing A Test That Will Shape Prospects For Recovery**

Perhaps the most startling development in the sukuk market in 2009 was the default of two issues, both of which have not been resolved at the time of publication of this report. This is a reminder to investors that default can and does happen in the sukuk market, as in other parts of the financial sector.

According to publicly available information, the recycling of short-term wholesale refinancing into longer-term assets—including private equity investments—resulted in liquidity pressure for TID. That led TID to default in 2009 on its sukuk as a part of a general debt restructuring program. We understand that TID has been working with its advisers on a restructuring plan and was close to reaching an agreement with creditors at the time of publication of this article. Saad Group also defaulted on its \$650 million sukuk.

The market was also concerned by the potential default of Nakheel on its sukuk that matured Dec. 14, 2009. It avoided default thanks to a last-minute support package from Abu Dhabi (foreign currency AA/Stable/A-1+, local currency AA/Stable/A-1+).

The two default cases stand to provide the market with insights into resolution after default. However, resolution is taking its time and we understand that some of the main uncertainties are:

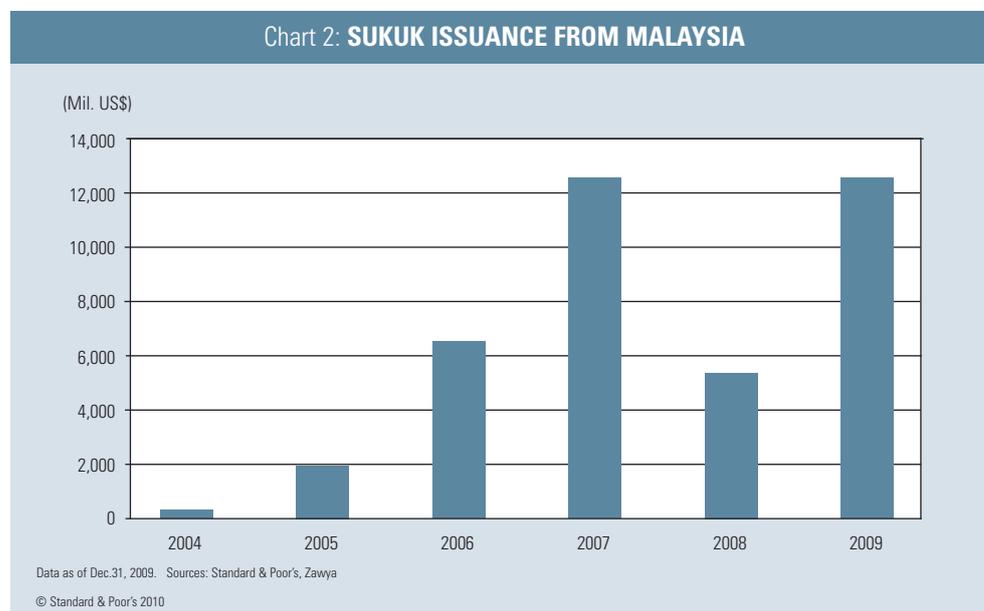
- How the court will treat the claims of sukuk holders in terms of ranking;
- How much holders will be able to recover and whether they will have access to the underlying assets; and
- How the sukuk's legal mechanisms will work with respect to the legal system to be applied and recognition of foreign legal decisions in local jurisdictions for sukuk issued locally under English law.

Once these default cases are resolved and depending on the outcome, investors will probably have better insight into loss given default for similar types of transactions. It is important to note that we have not revised our sukuk rating methodology following these defaults because our credit rating on sukuk only refers to relative credit risk or relative risk of default.

In particular, based on our methodology, our ratings on sukuk with full credit enhancement mechanisms are not based on the underlying assets but on the credit enhancement mechanisms that the sponsor of the transaction provides. The sponsor's obligations, under these mechanisms, typically rank *pari passu* with their other senior unsecured claims. Therefore, in principle, our ratings on this type of sukuk will continue to reflect the senior unsecured ratings on their sponsors. For other types of sukuk and rating methodology, please see "Standard & Poor's Approach To Rating Sukuk," published on Sept. 17, 2007.

## Lead by Malaysia, Asia Confirmed Its Place As The Major Locomotive Of Sukuk Growth In 2009

Asia ended 2009 confirming itself as the major engine of growth for the sukuk market, accounting for 63.9% of issuance. Malaysia alone was the host country of 54.1% of issues (see chart 2).



Malaysia continues to lead in global issuance as well as to be a clear leader in Southeast Asia in Islamic banking. The country's well-established Islamic banking system, strong regulatory framework, and government support for Islamic finance enabled the country to become the world's largest source of sukuk issuance in 2009.

Malaysian sukuk issuances more than doubled in 2009 from 2008, when the market faltered due to fallout from the global financial crisis and comments by some Sharia scholars about the Sharia compliance of sukuk that had been already been issued. Issuance out of Malaysia during 2009 reached \$12.6 billion and slightly exceeded the 2007 record of \$12.3 billion. The UAE, the other sukuk locomotive, experienced a falloff in issuance that started in 2007 and that continued throughout 2009.

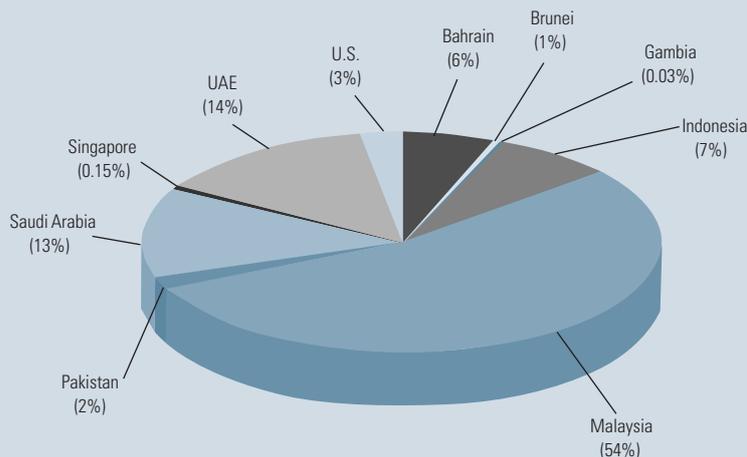
The 65 sukuk issues coming out of Malaysia, representing approximately 48% of the number of issues worldwide in 2009, further attest to the depth of the country's sukuk market. Key initiatives that the Malaysian government introduced in recent years--from establishing the Malaysian International Islamic Finance Centre; to promoting the country as a global leader in Islamic finance; to introducing various tax exemptions to Islamic banks, brokerages, takaful, and offshore sukuk investors--have encouraged many corporates and government-related entities (GREs) alike to participate in the domestic market. Last year's sukuk issuers included large corporates such as PetroliaM Nasional Bhd. (Petronas, A-/Stable/--) and Sime Darby (not rated), as well as prominent GREs such as Terengganu Investment Authority (not rated), and Cagamas (not rated).

Standard & Poor's expects a steady increase in sukuk issuance in Southeast Asia over the next couple of years, as issuers in the region, in particular those outside of Malaysia, become more interested in Islamic securities. We are expecting Indonesia and Singapore, in particular, to account for a bigger share of sukuk issuance in the years ahead.

The Gulf region continued to play a significant role in the development of the market, contributing 33.5% of total new issuance (see chart 3). The sukuk issued by Saudi Electric Co. (AA-/Stable/--) and the Emirate of Dubai (not rated) underpinned this performance. However, the UAE has played a less important role than in the past. That's because of the major economic

slowdown in the UAE and the correction of Dubai's real estate sector. In our view, also playing a role was Dubai World's request for a standstill agreement from its creditors and subsequent uncertainty, recently resolved, about the Nakheel sukuk. These events cloud prospects for Dubai-based issuers, in our opinion, making investors more risk-averse. That sentiment could potentially spread to other Gulf countries as well, and impede access to the market for some issuers there. One brighter spot in the Gulf is Saudi Arabia, with its strong pipeline of government-sponsored projects, some of which, we understand, may be financed through sukuk issuance.

Chart 3: SUKUK ISSUANCE BY COUNTRY, 2009



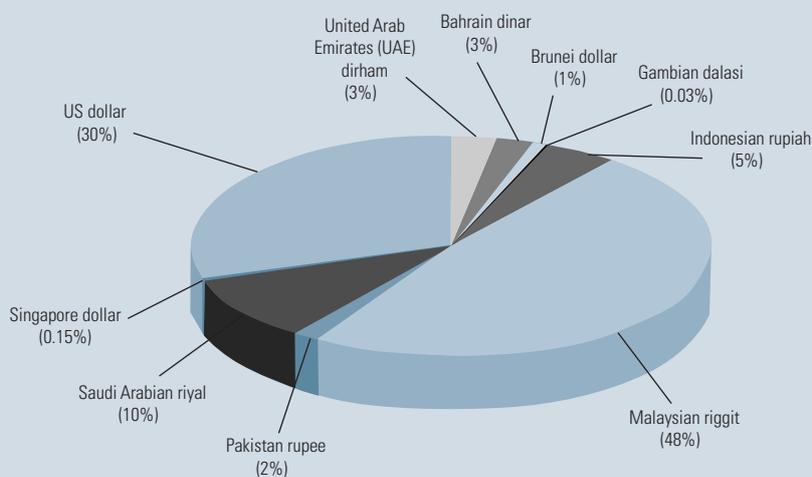
Data as of Dec. 31, 2009. Sources: Standard & Poor's, Zawya.  
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The year 2009 also saw the return of U.S.-based issuers to the sukuk market. With their issuance, the International Finance Corporation (foreign currency AAA/Stable/A-1+) and General Electric Capital Corp. (AA+/Stable/A-1+) made a \$600 million contribution to market growth in 2009.

### Local Currencies Are In Favor Now, But U.S. Dollar Is Slowly Coming Back

The U.S. dollar lost its leadership position as the currency of choice for sukuk issuance in 2008, accounting for only about 10% (see chart 4). However, in 2009 it made a gradual

Chart 4: SUKUK ISSUANCE BY CURRENCY, 2009

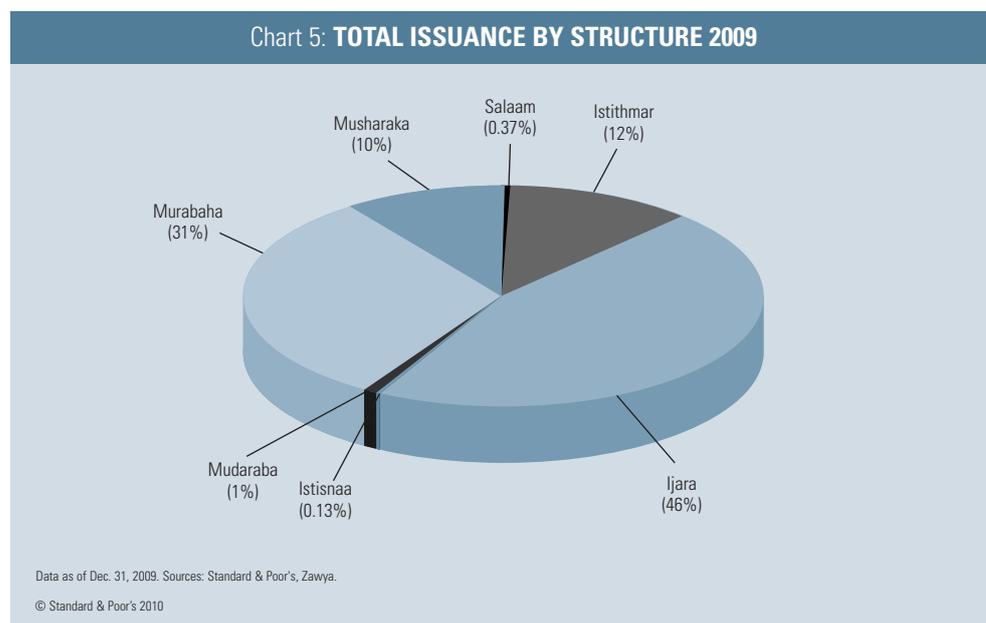


Data as of Dec. 31, 2009. Sources: Standard & Poor's, Zawya.  
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comeback, representing about 30% of issuance. The remainder was in the local currencies of the countries of issuance. The U.S. currency is likely to only slowly regain its position because of tight liquidity on international markets and the relative weakness of the currency. Issuers have therefore been focusing on local markets with more abundant liquidity and where appetite for Sharia-compliant instruments is stronger. Therefore, Standard & Poor's expects local currencies to dominate issuance in the next 12 months, with the U.S. dollar taking up a relatively limited portion. This is the case in Malaysia, for example, where the market is deeper and the need for foreign currency-denominated issuers appears to be lower. Once market conditions return to normal, dollar-denominated sukuk should regain a stronger position.

### Ijara And Murabaha Structures Dominate As The Market Shies Away From Other Structures

Ijara and murabaha structures accounted for about three-quarters of total sukuk issued in 2009, and we expect that trend to continue for the next 12 months (see chart 5). The remainder were in the form of istithmar, wakala, musharaka, and salam structures. The market remains unsettled by comments some Sharia scholars have made regarding the compliance of some sukuk issued so far. As a result, the market has shied away from musharaka and has been using other forms. We believe the lack of standardization in terms of Sharia interpretation is a major element preventing the emergence of a truly integrated global sukuk market. (For definitions of these structures, see "Glossary Of Islamic Finance Terms," published Jan. 7, 2008.)



We note that governments and government-related entities (GREs) were the biggest issuers of sukuk in 2009. To us, this indicates that the appetite for private sector issuance remains somewhat limited, except for well-established names with regular access to the market. We believe that government and GRE issuance is helpful to the development of the market. The pricing of these issues helps the market to construct benchmarks for private sector issuers. We believe that government and GRE issuance will continue to boost the market, at least until market conditions improve.

# Islamic Banking Has Reached Critical Mass In The Gulf After Sustained Growth, And Expansion Is Set To Continue

Standard & Poor's Ratings Services believes that Islamic banking in the Gulf region has evolved in the past decade from a niche market to an important segment of the local banking industry, and has now reached critical mass. We estimate that Islamic banking assets in the Gulf Cooperation Council (GCC) reached \$285 billion at year-end 2008, amounting to a market share of 22% of total banking assets, compared with less than 10% in 2003.

In our opinion, the most important factors explaining the fast growth of Islamic banking assets in the Gulf are strong government involvement, increasing demand for and offer of Islamic products, and the entrance of numerous new players. As a result, competition is mounting. Conventional banks' Islamic offerings appear to pose the biggest threat to pioneering Islamic banks that used to have a monopoly in their domestic niche markets.

Since summer 2008, the economic downturn has affected the Islamic banking sector in the Gulf, especially in Kuwait and Dubai, because of the direct and indirect effects of the correction in the real estate and equity markets. We believe longer-term growth prospects are still good, though, as we expect Islamic banking products to continue replacing plain vanilla conventional products and services. Government involvement and support remains strong and key to the sustained growth of the sector in our view.

## The Gulf Is Among The Largest Islamic Banking Markets In The World

Excluding banking assets of the Sultanate of Oman (A/Stable/A-1), where Islamic banking is not allowed, and assets of the Bahraini wholesale banking sector, which operates mainly outside of Bahrain, the market share of Islamic banking assets in the GCC would reach 26%. Our calculation, and the figures mentioned in this article that derived from it, are based on data publicly reported by Gulf-based banks and central banks (see breakdown by bank at year-end 2008 in the Appendix).

At year-end 2008, 24 fully-fledged Islamic banks were operating in five member states of the GCC: the Kingdom of Saudi Arabia (AA-/Stable/A-1+), the United Arab Emirates (not rated), the State of Kuwait (AA-/Stable/A-1+), the State of Qatar (AA-/Stable/A-1+), and the Kingdom of Bahrain (A/Stable/A-1).

Although we believe our \$285 billion estimate provides a good proxy of the current level of development of Islamic banking in the region, it is only approximate. It does not include assets held by major international banking groups that are also active in Islamic banking in the region, like, among others, HSBC Holdings PLC, Deutsche Bank AG, and BNP Paribas. It also relies on the banks' willingness to publish detailed data and central bank requirements.

Islamic banking is only one component of Islamic finance. An exhaustive measure of the size of Islamic financial assets in the GCC at year-end 2008 would in our view require the aggregation of assets held by other types of financial and quasi-financial institutions at that date including, for example:

- Assets of the Islamic Development Bank (AAA/Stable/A-1+, \$11.2 billion);
- Assets of Sharia-compliant investment companies in Kuwait (\$28 billion);
- Assets of Sharia-compliant (takaful) insurance companies;

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### Publication date:

4-Dec-2009

- Sharia-compliant securities (sukuk or the Islamic equivalent to bonds, see “The Sukuk Market Has Continued to Progress in 2009 Despite Some Roadblocks,” published on Sept. 2, 2009) issued by corporate or sovereign entities and not already carried by Gulf banks;
- Sharia-compliant mutual funds; and
- Equity securities that are deemed Sharia-compliant.

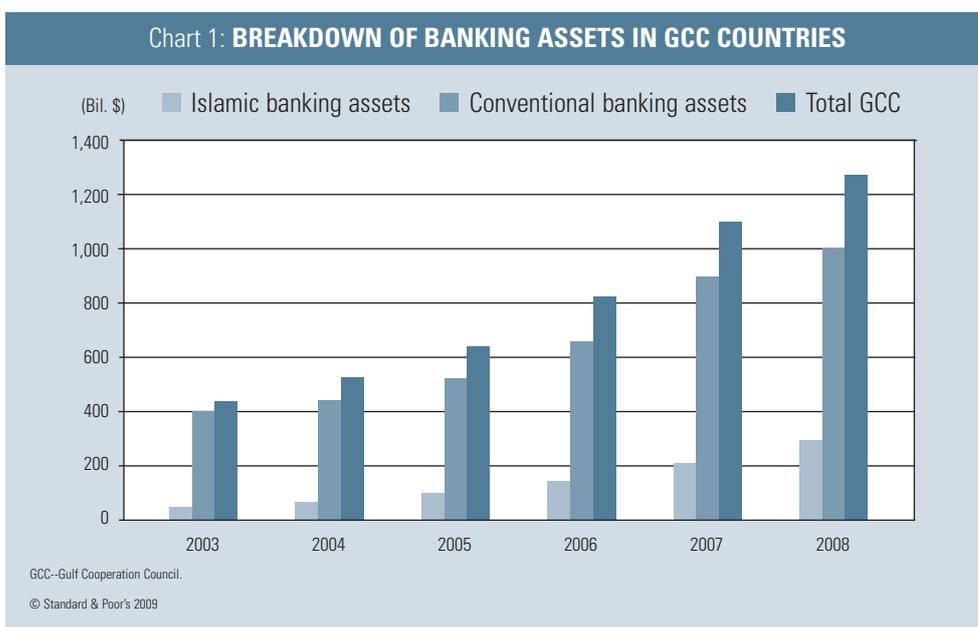
The GCC Islamic banking market is one of the largest in the world. Other markets with sizable Muslim populations include India (BBB-/Negative/A-3), Indonesia (foreign currency BB-/Positive/B, local currency BB+/ Positive/B), Iran (not rated), Malaysia (foreign currency A-/Stable A-2, local currency A+/Stable/A-1), Nigeria (B+/Stable/B), Pakistan (B-/Stable/C), and Turkey (foreign currency BB-/Stable/B, local currency BB/Stable/B). In these markets, the penetration of Islamic banking varies broadly: It has an embryonic status in Nigeria and accounts for about 13% of banking assets in Malaysia. We estimate that total global Islamic finance assets stood at about \$800 billion at year-end 2008. In our opinion, the increase in 2009 and at least early 2010 will be rather modest because of the global economic downturn.

Overall, the Islamic financial sector remains relatively small by international standards. A bank with total assets of about \$800 billion would rank as the 30th largest bank in the world. However, by regional standards, the market share of Islamic banking in the GCC is material. It has been growing very rapidly, and we expect it will continue expanding, but at a slower pace in the near future.

The fully-fledged commercial Islamic banks in the GCC constitute the most visible part of the Islamic banking sector, but their relative market share is declining because several conventional commercial banks have entered this field since the early 2000s through specialized divisions (“Islamic windows”) or subsidiaries. These Islamic windows accounted for 29% of GCC Islamic banking sector assets at year-end 2008. Among conventional local banks, Saudi entities are the most active and accounted for 86% of Islamic banking assets of conventional banks. The growing importance of conventional players is a recent development that we believe partly explains the recent rapid growth of Islamic banking assets.

### Growth Of Islamic Banking Assets Has Exceeded That Of Conventional Banking Assets

In recent years, we have observed that the growth of Islamic banking assets has outstripped

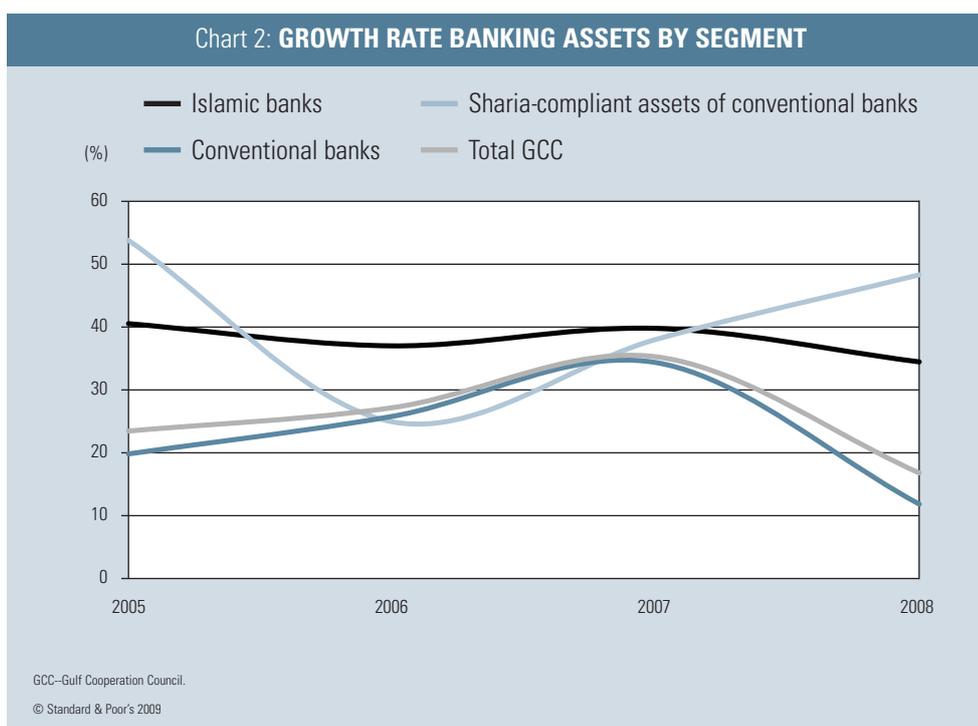


that of conventional banking assets, even given rapid asset growth systemwide. According to our calculation, conventional banking assets nearly tripled between 2003 and 2008, while Islamic banking assets have been multiplied by seven, albeit starting from a much lower base (see chart 1).

Undoubtedly, the Islamic banking sector has benefited, like conventional banking, from a very supportive economy. Other factors specific to the sector, though, help explain why the growth of this segment has been so strong in our view.

We understand that demand for Sharia-compliant banking products has increased not only from retail customers, deemed the most interested in Sharia-compliant products, but also from private sector corporate and government-related entities. At the same time, financial innovation has contributed to facilitating the supply of financial products and services, from retail products, like housing or car financing programs, to more sophisticated products like sukuk or mutual funds.

On the supply side, some banks are shifting from conventional to Islamic banking, either through a full transformation or following a business diversification strategy. In fact, the most dynamic growth in Islamic banking comes from conventional banks (see chart 2). It appears that they have enlarged or transformed their product suite to attract new customers or avoid losing existing ones. We see this evolution as a substitution, whereby conventional banks offer new products that compete with the ones that they already offer.

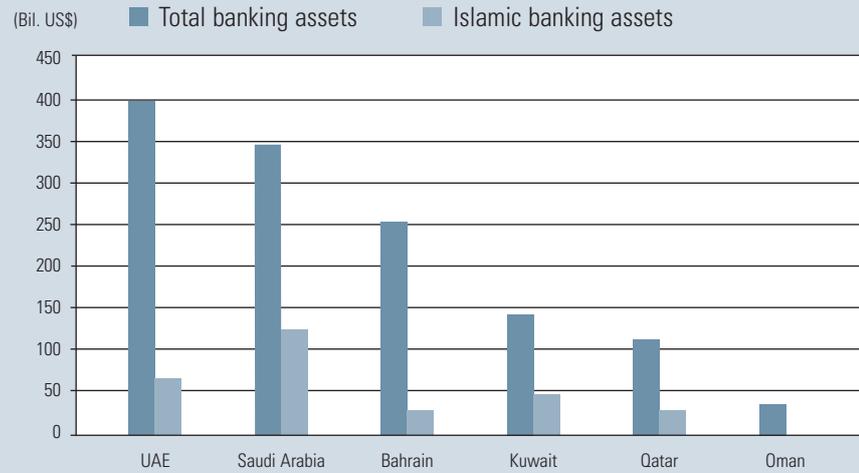


The entrance of Saudi conventional banks in 2003-2004, making their retail business lines Sharia-compliant, has largely contributed to the growth of Islamic banking assets in these years. Regulators have also allowed conventional banks to enter this field through Islamic windows in Qatar (in 2005) and in the UAE (in 2006).

### The Market Share Of Islamic Banking Assets In The Gulf Varies Widely Among Countries

While we estimate that Islamic banking accounted for 22% of total banking assets in the GCC region in general, market penetration varies widely among member states, ranging from 9.8% in Bahrain (19% for Bahraini retail banks alone) to 37% in Saudi Arabia (see chart 3).

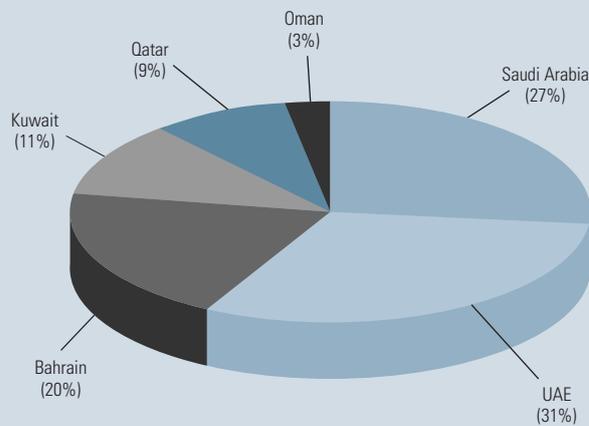
Chart 3: MARKET PENETRATION OF ISLAMIC BANKING IN GCC COUNTRIES



GCC--Gulf Cooperation Council. UAE--United Arab Emirates.  
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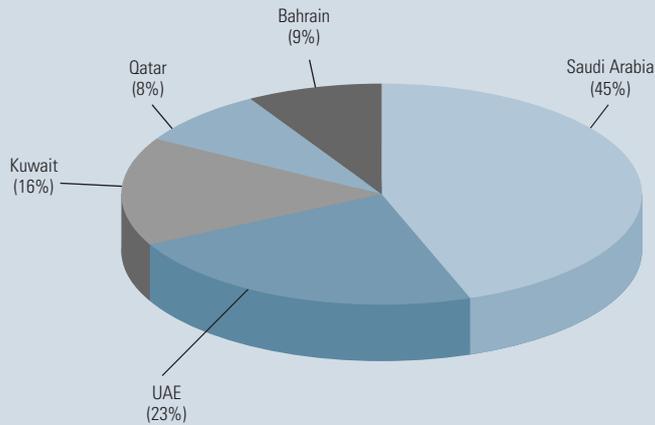
As a result, the geographical breakdown of Islamic banking assets as at the end of 2008 in the GCC by country does not match the geographical breakdown of total banking assets. Saudi banks, both Islamic and conventional, hold about 45% of Islamic banking assets in the Gulf region compared with 27% of total banking assets (see charts 4 and 5).

Chart 4: BREAKDOWN OF TOTAL BANKING ASSETS IN THE GCC



Data as of Dec. 31, 2008. GCC--Gulf Cooperation Council. UAE--United Arab Emirates.  
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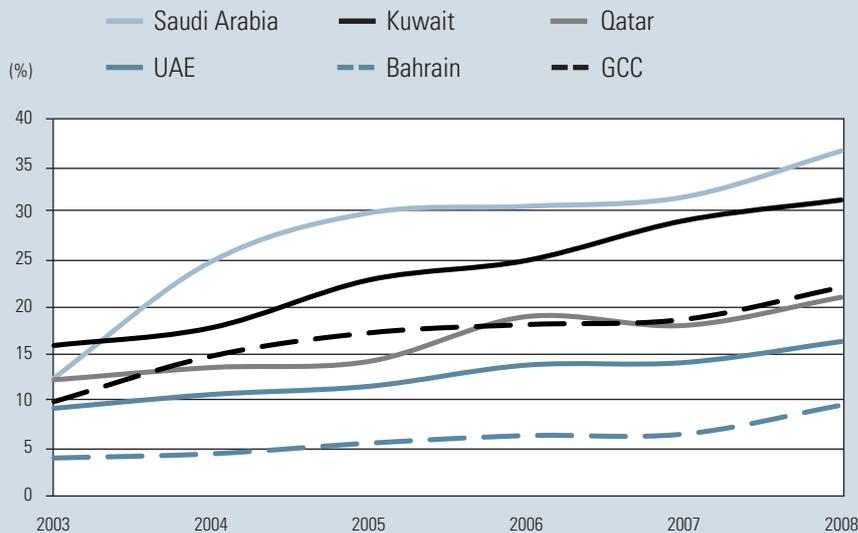
Chart 5: **BREAKDOWN OF TOTAL ISLAMIC BANKING ASSETS IN THE GCC**



Data as of Dec. 31, 2008. GCC--Gulf Cooperation Council. UAE--United Arab Emirates.  
© Standard & Poor's 2009

This suggests to us that key structural differences among GCC countries remain, including in our view barriers to entry in Islamic finance for conventional banks. On the other hand, all countries, with the exception of Oman, have experienced a steady growth of Islamic banking assets over the past five years (see chart 6).

Chart 6: **ISLAMIC BANKING MARKET SHARE IN THE GCC**

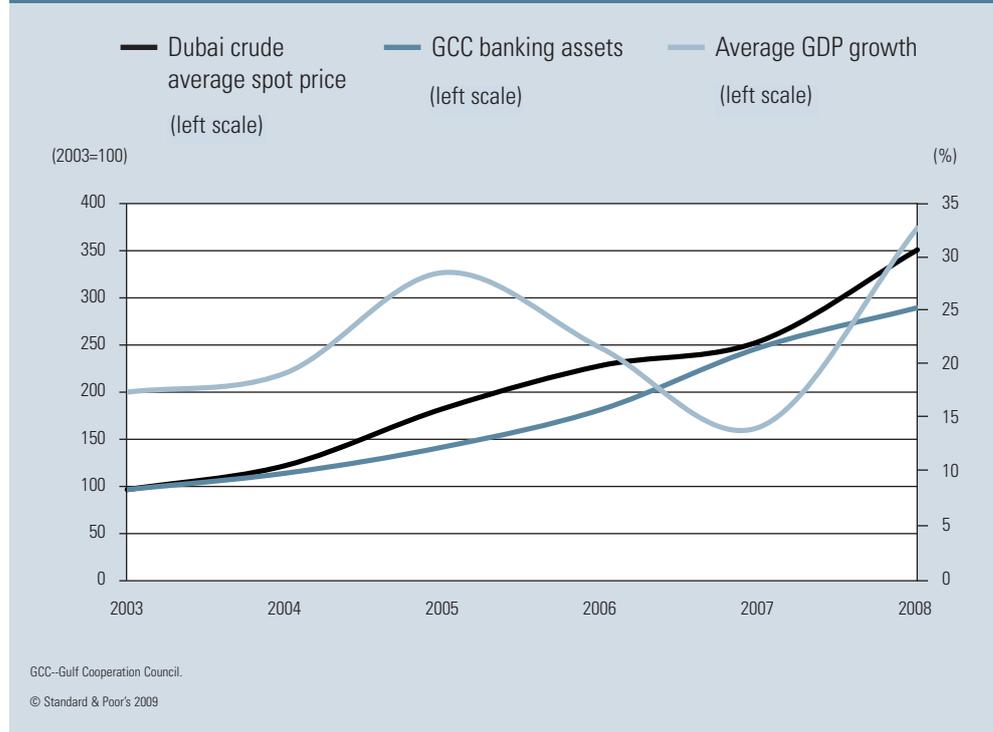


GCC--Gulf Cooperation Council. UAE--United Arab Emirates.  
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## Economic Prosperity Has Boosted Islamic And Conventional Banking Alike

Islamic banking--like the conventional banking segment--has benefited from local economic momentum. The dynamism of the GCC economies is strongly associated with the performance of the oil and gas industries (see chart 7). Oil and gas prices have boomed in recent years, fueling the growth of banking assets in the Gulf.

Chart 7: GROWTH RATE OF BANKING ASSETS COMPARED WITH OIL PRICES AND GDP GROWTH



Thanks to high oil and gas prices, governments have launched many initiatives, including the development of financial services, to diversify local economies and reduce the overreliance on the oil and gas industries. The authorities established new financial centers, such as the Dubai International Financial Centre (DIFC) and the Qatar Financial Centre (QFC), with attractive legal frameworks. Governments also modernized the capital market infrastructure.

The diversification strategy was not limited to the development of financial services. Governments have undertaken vast programs to enhance local infrastructure, from public utilities and transportation to education services and the creation of new cities. Banks have played a key role in financing these projects, as financial disintermediation is still limited in the Gulf. On the retail side, the local bankable population, including the expatriate segment, has also increased. Overall, since early 2000, the need for banking services has increased, creating many new business opportunities for banks in the region.

At the same time, Gulf investors' interest in investing locally appears to have grown. Investor focus on the region further strengthened with the oil and gas boom. We believe it even accelerated with the downturn of the international financial markets, as bright prospects for the local oil and gas industries appeared to offer a shield against the global economic downturn. For some time, there seemed to be an impression that local economies would remain insulated from the slowdown of the global economy.

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

The strong direct and indirect government support in favor of the development of Islamic banking in most GCC member states is a key driver of its long-term growth in our view. Government support has in our view taken three forms.

- State authorities are instrumental in the implementation of an adequate and supportive regulatory framework. In some cases, Islamic banks have special derogations, such as a late implementation of Basel II for Islamic banks in Kuwait, or greater flexibility to invest in real estate assets in Qatar.
- The granting of banking licenses is a discretionary power of the state authorities. In fact, most of the newly established banks in the region are Islamic banks. State authorities also control the transformation of the banking system, allowing conventional banks to transform into Islamic ones (like Bank of Kuwait & The Middle East in Kuwait and Sharjah Islamic Bank and Dubai Bank in the UAE), open dedicated business lines (in Saudi Arabia, Qatar, and the UAE), or acquire Islamic banking subsidiaries, as in the case of National Bank of Kuwait S.A.K. which recently acquired a controlling stake in Boubyan Bank.
- Last, but not least, local governments have been direct and indirect stakeholders in Islamic banks, such as Kuwait Finance House, Dubai Islamic Bank, Dubai Bank, and Al Rajhi Bank, and more recently Alinma Bank, First Energy Bank, and Al Hilal Bank. This strategy best illustrates the strong and direct involvement of state authorities in the development of the sector.

Table 1: **RECENTLY ESTABLISHED BANKS IN THE GCC**

<b>Conventional banks</b>		
Oman	Bank Sohar SAOG	2006
	Oman Merchant Bank	2007
<b>Islamic banks</b>		
Kuwait	Boubyan Bank	2004
Saudi Arabia	Bank Albilad	2004
	Bank Alinma	2006
Qatar	Masraf Al Rayan	2006
UAE	Al Hilal Bank	2007
	NoorIslamic Bank	2007
	Ajman Bank	2008
Bahrain	Al Salam Bank-Bahrain	2006
	Khaleeji Commercial Bank	2004
<b>Conventional banks turning Islamic</b>		
Saudi Arabia	Bank Al Jazira	2004
Kuwait	Kuwait International Bank	2007
	Bank of Kuwait & The Middle East	2009 (expected)
United Arab Emirates	Sharjah Islamic Bank	2002
	Emirates Islamic Bank PJSC	2004
	Dubai Bank	2007

## **Islamic Banking Assets Have Increased Because Of The Entrance Of Many New Players And Expansion Outside Of The GCC Region**

Standard & Poor's believes that rapid asset growth and above average profitability, thanks to competitive advantages in a nascent market, have attracted many new players to Islamic finance. In our view, this can largely be seen as an opportunistic move for conventional players, who use Islamic finance to enhance business diversification when they face increased competition from local and foreign banks in their domestic markets.

Total assets have therefore increased as a result of the higher number of institutions active in this field, either newly-established Islamic banks, conventional banks turning Islamic, or conventional banks entering the segment through Islamic windows. For the time

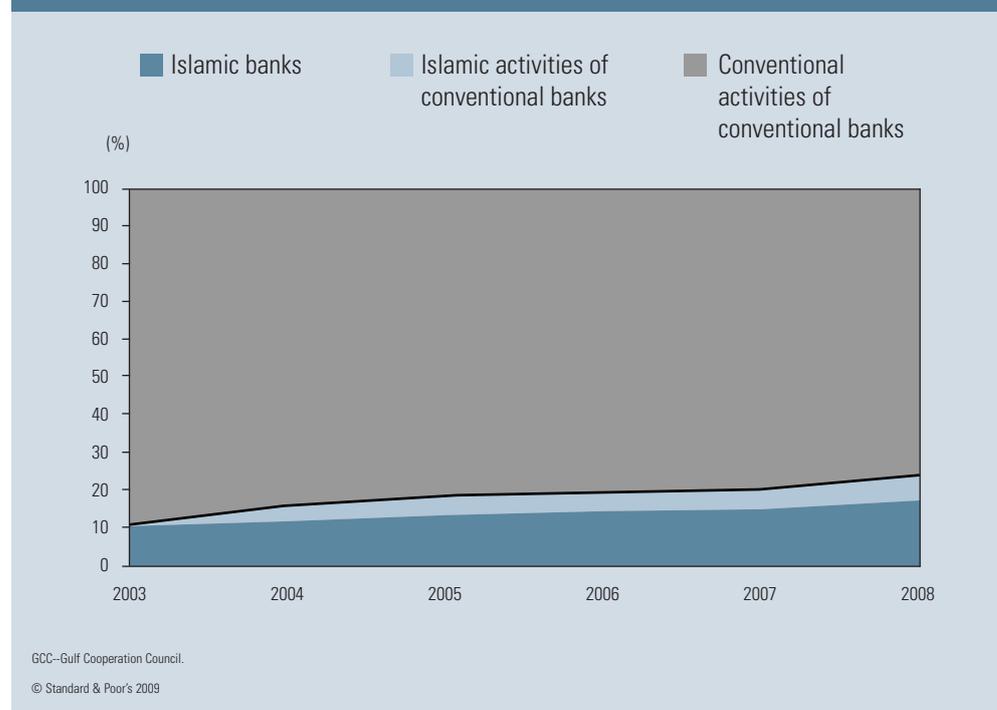
being, competitors are only GCC players and international banking groups. Banks established in non-Arab Muslim countries like Malaysia have not entered the GCC market.

Foreign assets have also increased as a result of an active geographic diversification strategy pursued by traditional players facing increased competition in their home markets and aiming to seize the first mover advantage in nascent foreign markets. About 25% of Kuwait Finance House's assets are located outside of Kuwait, and the bank operates banking subsidiaries in Bahrain, Turkey, and Malaysia, from which we understand it intends to further develop its physical presence. National Commercial Bank acquired an Islamic lender in Turkey in 2008 (Turkiye Finans Katilim Bankasi A.S., not rated). Al Rajhi Bank established a subsidiary in Malaysia in 2005. Albaraka Banking Group (B.S.C.) (BBB-/Stable/A-3), a wholesale Islamic bank in Bahrain, has followed this business model for a long time, with an established presence in various countries including Turkey, Algeria, and Indonesia.

### Competition Is Mounting, With Conventional Banks' Islamic Windows Actively Challenging Fully-Fledged Islamic Banks

Pioneering Islamic banks that have managed to acquire quasi-monopolies in their domestic niche markets are now facing stiff competition in our opinion. Their first mover advantage is shrinking in their domestic markets and we understand they are now looking at business and/or geographic diversification strategies. Conventional banks entering Islamic banking currently constitute the most active competitive threat to established Islamic banks. The latter accounted for 71% of sector assets at year-end 2008 compared with nearly 100% in 2003 (see chart 8).

Chart 8: THE GROWING IMPORTANCE OF ISLAMIC BANKING ACTIVITIES OF CONVENTIONAL BANKS



This is mainly explained by the entrance of conventional Saudi banks making their retail business Sharia-compliant. The market shares of conventional Qatari and UAE banks, through Islamic windows, are also expected to grow rapidly. The business model of

commercial Islamic banks in the Gulf is in our view focused on offering alternative banking products and services to their customers, rather than entering into new segments like venture capital or microfinance. This inclination has in our view generally eased the substitution of conventional banking products and services by Sharia-compliant equivalents. Markets are therefore slowly moving from monopolies or oligopolies to much more competitive structures.

### **Islamic Banks Were Shielded From The Subprime Crisis, But Are As Exposed To Asset Quality Deterioration As Conventional Peers**

Islamic banks did not directly suffer from the subprime crisis since they were prohibited from investing and trading in fixed-income products. They are, however, just as exposed as conventional banks to the consequences of the global economic slowdown and its impact on the GCC. During the first half of 2009, we observed that banking assets in the GCC declined by 1.1%, while assets of the five largest Islamic banks increased by 1.3%, compared with a rise of 17% and 21.5%, respectively, in 2008.

Since commercial Islamic banks offer financing facilities through alternative non-interest-bearing transactions, they are therefore, in our view, highly likely to be exposed to asset quality deterioration, like their conventional peers. The weighted average ratio of nonperforming financing facilities (mainly murabaha and ijara transactions) to total financing facilities increased to 5.1% at year-end 2008, from 3.1% a year before, for the five largest Islamic banks in the region. We have noted that this deterioration of asset quality indicators continued in 2009, and we expect the trend to remain negative in 2010.

The asset-backed nature of Islamic banking may only mitigate risks to the extent that banks have the ability to rely on legal systems to enforce their claims in case of foreclosure, which is doubtful in the Gulf for residential properties, and if local markets are liquid enough for the banks to liquidate assets. Because of these risks, typically we consider that lending policies are not materially different between Islamic and conventional banks. In retail banking in the Gulf, the common practice of assigning salaries, especially for government employees, is therefore likely to provide a better protection than the retention of ownership rights on the goods financed.

The Islamic banking sector has also been affected, like the conventional sector, by the decline of revenues derived from brokerage fees and trade finance related fees. We believe it is also highly exposed to the downturn of the real estate and construction markets.

Despite the limited array of products available for liquidity management, we understand that Islamic banks did not especially suffer from liquidity shortages. Limited access to liquidity management products tends to mean simpler liquidity management, for example holding a higher portion of the balance sheet in cash or short-term bank placements. In addition, Islamic banks had equal access to the supportive measures implemented by local governments.

### **Growth Prospects Are Good In Our View, But Constraints Remain**

We believe that growing demand, active government backing, easy substitution between Islamic and conventional products, and efforts by conventional players to develop their footprint in this field are all indicators that the market share of Islamic banking will continue to progress. However, we do not expect Islamic banking to grow at the same pace as in the past decade. Several factors are likely to constrain its development in our view:

- Not all conventional products have an Islamic equivalent. This is especially true for treasury products and liquidity management tools (see “Risk Management For Islamic

- Financial Institutions: A Rating Perspective,” published on Jan. 15, 2008).
- Limited product standardization constrains the integration of market players into the international financial sphere. It is unclear at this stage, if in the medium term, banks will be able to distribute standardized Islamic banking products throughout a market continuum from the Middle East to Southeast Asia and beyond, or if the Islamic finance market will remain geographically compartmentalized, limiting economies of scale.

## Presale:

# GE Capital Sukuk Ltd.'s Trust Certificates

## GE Capital Sukuk Ltd. Trust Certificates Assigned Preliminary 'AA+' Rating

### Rationale

Standard & Poor's Ratings Services bases this presale report on information as of Nov. 8, 2009. We are posting the report in conjunction with the planned issuance of sukuk (trust certificates) by GE Capital Sukuk Ltd., a limited liability exempted company incorporated under the laws of Bermuda. The sukuk assets primarily consist of ownership interests in aircraft assets and rights under the lease agreements entered into regarding the aircraft assets. Sukuk Aviation Leasing Inc. (SAL), a fully owned subsidiary of General Electric Capital Corp. (GECC; AA+/Stable/A-1+), will sell its beneficial interests in aircraft assets to the issuer, act as the servicing agent of the transaction, and undertake to purchase the underlying assets at maturity. The obligations of SAL to GE Capital Sukuk Ltd. will be unconditionally and irrevocably guaranteed by GECC. This guarantee will rank pari passu with GECC's other senior unsecured obligations. The guarantee underpins our equalization of the 'AA+' rating on the sukuk with our long-term counterparty credit rating on GECC.

The 'AA+' rating assigned to the trust certificates is preliminary and based on draft documentation. If final documentation differs substantially from the draft version, the rating on the trust certificates could be revised or withdrawn. This report does not constitute a recommendation to buy, hold, or sell the certificates.

### Issuer, Purchaser, and Trustee

GE Capital Sukuk Ltd.

### Obligor, Seller, and Servicing Agent

Sukuk Aviation Leasing Inc. (SAL)

### Guarantor of SAL's Obligation to GE Capital Sukuk Ltd.

General Electric Capital Corporation.

### Lead Managers

Citigroup Global Markets Limited.  
Goldman Sachs International.  
Liquidity Management House for Investment Co. K.S.C.C.  
National Bank of Abu Dhabi.

### Delegate

BNY Corporation Trustee Services Limited.

### Principal Paying Agent

The Bank of New York Mellon.

### Registrar and Transfer Agent

The Bank of New York Luxembourg S.A.

### Governing law

English law and New York law.

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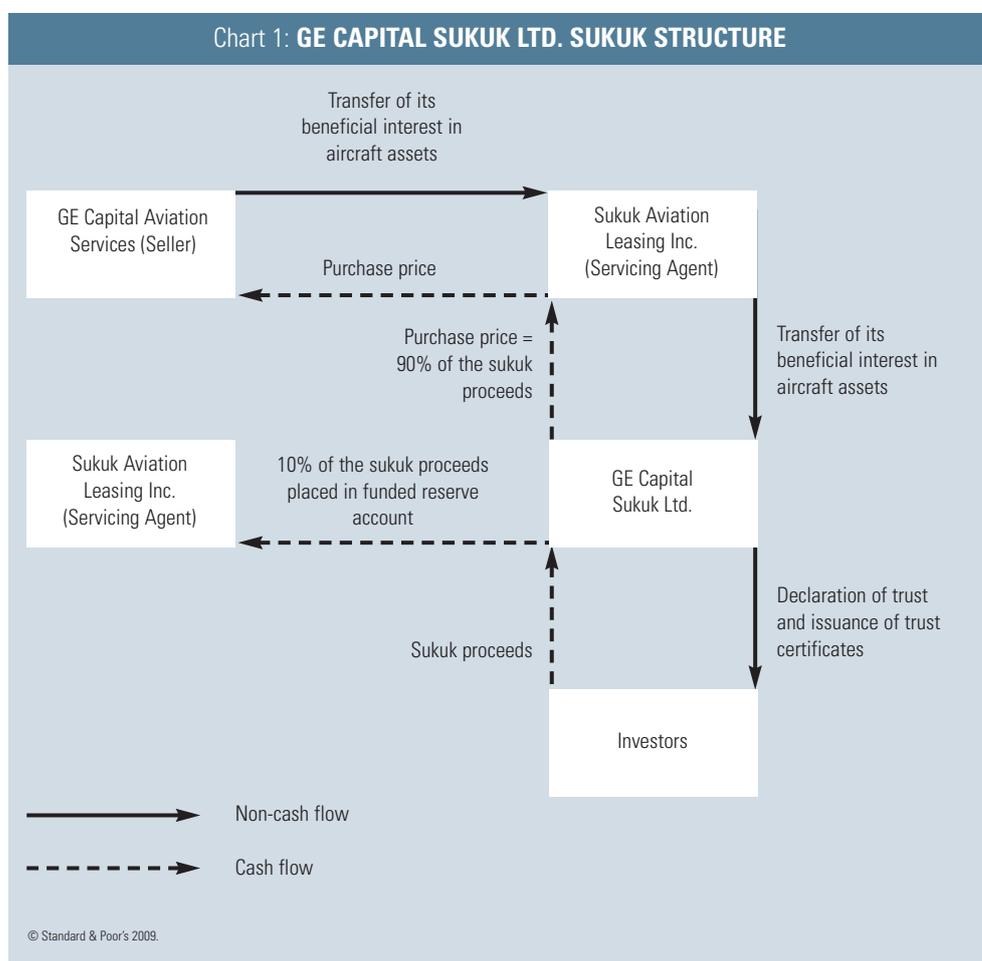
### Publication date:

16-Nov-2009

### Profile

The sukuk involves GE Capital Sukuk Ltd. (the issuer), a limited liability exempted company incorporated under the laws of Bermuda, issuing rated sukuk “al ijara” (leasing) trust certificates. The issuer will use a maximum of 90% of the sukuk proceeds to enter a purchase agreement with SAL to purchase beneficial interests in a pool of aircraft assets originated and owned by various subsidiaries of GECC and managed by GE Capital Aviation Services (GECAS), a wholly owned subsidiary of GECC. The issuer will hold beneficial interests in the pool of aircraft assets on behalf of the sukuk holders. The issuer will pay the remaining proceeds to SAL, which will hold them in a funded reserve account (FRA) through deferred payment commodity “murabaha” (buy-and-sell) transactions. SAL will be appointed as servicing agent.

GECC will guarantee all obligations of SAL, including the servicing agency agreement, each murabaha contract, the purchase undertaking, the purchase substitution undertaking, the insurance undertaking, and the declaration of trust, each entered into in connection with the trust certificates.



### Periodic Distribution

As the servicing agent, SAL will collect the rent payments on the leased assets, which will form the basis for the periodic distribution payments of the trust certificates. SAL will retain any excess cash flow above the periodic distribution amount in an unfunded reserve account (URA) for the benefit of the issuer. Penalty interest payments for delayed payments, if any, will be paid by SAL to charitable institutions. The URA will be used to pay an advance incentive fee to SAL.

In the event of the total loss or destruction of one or more, but not all, of the aircraft assets forming the underlying pool of assets, a replacement aircraft account (RAA) would be credited by

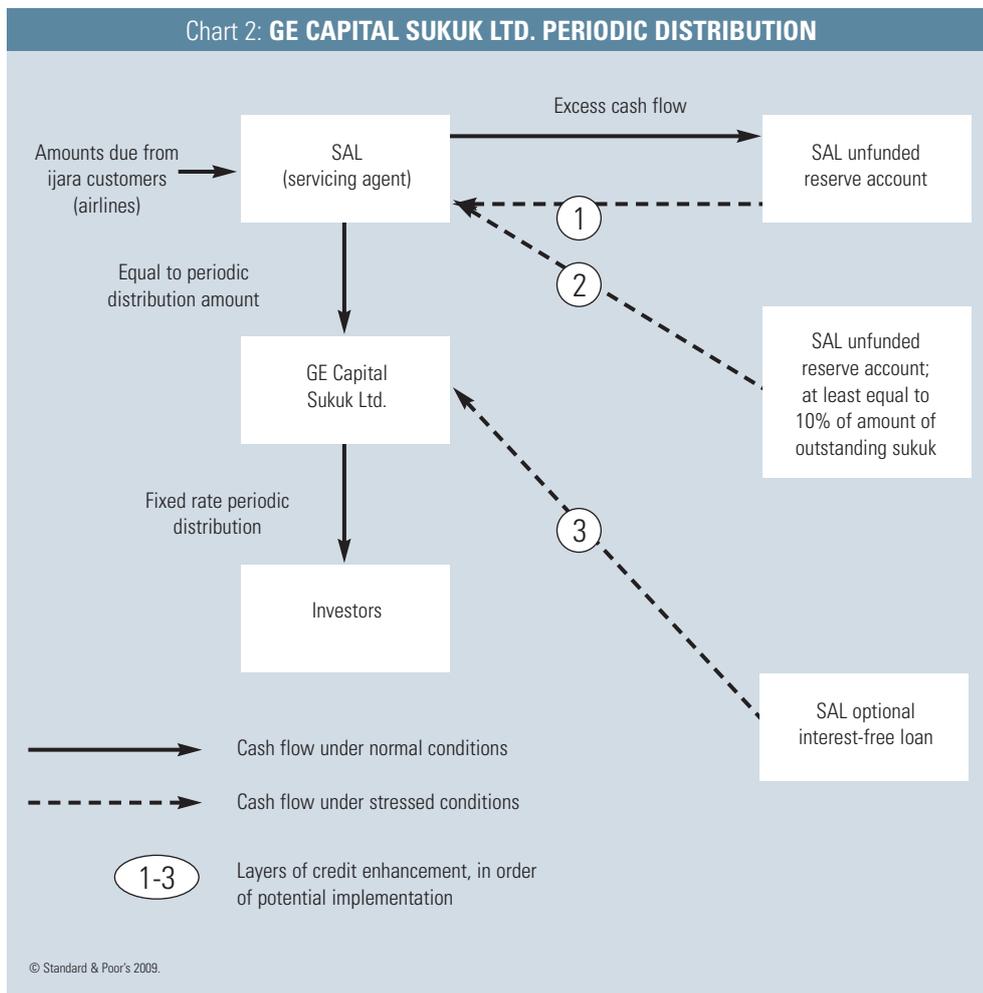
the insurance proceeds collected by SAL, on behalf of the issuer in its capacity as servicing agent. In addition, SAL, as in its capacity as servicing agent, would pay any difference if the insured amount is less than the value ascribed to the aircraft assets representing outstanding sukuk.

If the rent payments fall short of the periodic distribution amount, the transaction benefits from three layers of enhancement, in order of potential implementation:

- SAL will credit back the advance incentive fee to the URA and draw on it;
- If funds available in the URA are insufficient, SAL will draw on the FRA;
- In the event of inadequate funds in these two accounts, SAL can choose to extend an interest-free loan to the issuer. This loan will be added to the exercise price in the purchase undertaking.

The option provided in the third layer of enhancement is mitigated by the fact that under the sukuk terms and conditions, and specifically under the purchase substitution undertaking (PSU), SAL in its capacity as obligor will undertake to purchase aircraft assets that would have been subject to a funding event (the “affected aircraft assets”). SAL will use all reasonable endeavors to identify and replace such assets when given at least 90 days notice ahead of the relevant periodic distribution date. The replacement assets will carry the same value, quality, and revenue generating properties as the affected aircraft assets. In addition to replacement assets, SAL under the PSU will pay the required cash amount to replenish the FRA.

A funding event means: a) that the FRA either has, or will have on the next periodic distribution date, a balance which is less than 10% of the aggregate face amount of the sukuk outstanding on that date, in each case as a result of some event or other occurrence regarding any



aircraft assets, other than the loss or destruction of the relevant aircraft assets; or b) that SAL gives notice of any material non-compliance with the terms of any lease agreement (material is defined according to the cash flow requirements).

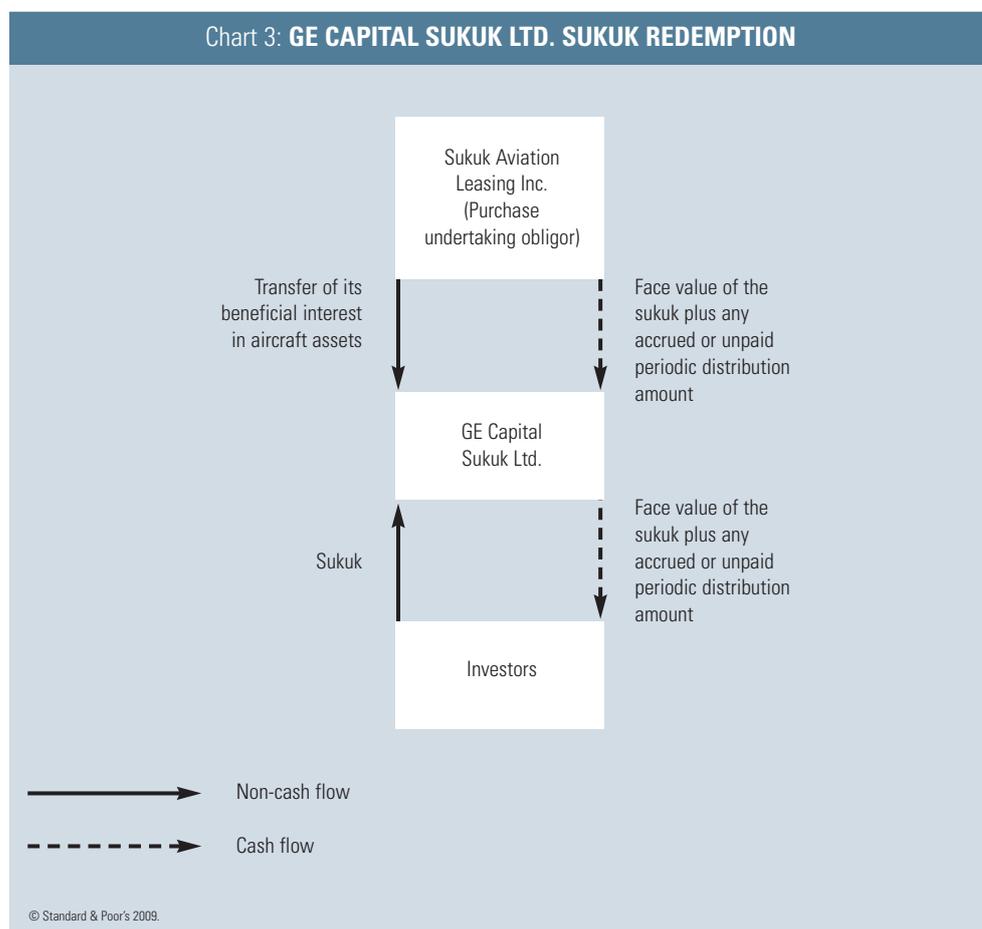
GECC will irrevocably guarantee SAL's obligations under the PSU; this guarantee will rank pari passu with all other senior unsecured obligations of GECC.

### Sukuk Redemption

Following the occurrence of a specific termination event, or "aircraft shortfall event," or on the scheduled termination date, SAL (under the purchase undertaking) has undertaken irrevocably to purchase, and the issuer (under the sale undertaking) has undertaken irrevocably to sell, the underlying assets for an amount equal to the aggregate face value of the sukuk plus any accrued or unpaid periodic distribution amount, plus any amounts outstanding under the interest free loan if extended by SAL, and an amount equal to any amount payable to the servicing agent under the servicing agency agreement. GECC will irrevocably guarantee SAL's obligations under the purchase undertaking. This guarantee will rank pari passu with all other senior unsecured obligations of GECC. An aircraft shortfall event would occur when the aggregate value of the aircraft assets is at any time less than 51% of the aggregate face amount of the sukuk outstanding at that time, and not cured within the cure period of not less than 30 days and not more than 60 days, as per the sukuk terms and conditions.

### Specific Termination Events

In the event of the total loss or destruction of one or more but not all of the aircraft assets, SAL as servicing agent will claim and collect all insurance proceeds on behalf of the issuer



(including any relevant payments made by the lessee of the aircraft assets) and make up any difference in the value ascribed to the aircraft assets (including an accrued rental payment for the period before amounts are required to be paid under the insurance undertaking) and the insured amounts. On receipt of the insurance proceeds or other amounts, which will be credited to the RAA, SAL will use:

- All reasonable endeavors to identify and procure the purchase by the issuer of eligible replacement aircraft assets (which will be of the same value, insofar as the replacement aircraft is concerned, and correspond in quality and revenue generating properties to the aircraft assets lost or destroyed); and
- The relevant amounts outstanding in the RAA in commodity murabaha transactions under the same terms as for the FRA during the period that SAL is unable to identify eligible replacement aircraft assets and purchase them.

If the relevant insurance proceeds are not paid within 30 days, SAL (in its corporate capacity) will pay the necessary amounts pursuant to the insurance undertaking to ensure there is no shortfall on the part of the issuer. In the event of the total loss or destruction of all the aircraft assets, the sukuk will be redeemed on the 30th day following this event, by way of a similar mechanism to that described above in order to ensure the repayment in full of the sukuk (including accrued but unpaid periodic distribution amounts).

### **General Electric Capital Corp (AA+/Stable/A-1+)**

Standard & Poor's Ratings Services' 'AA+' rating on General Electric Capital Corp. (GECC) reflects its ownership by General Electric Co. (AA+/Stable/A-1+) through intermediate holding company General Electric Capital Services Inc. (GECS; --/--/A-1+); GECC's strong, well-managed business franchise; its large scale and resources; its relatively good credit quality; and management's ongoing efforts to bolster liquidity and reduce funding risks. However, we are concerned about accelerating pressure on earnings from rising credit losses in the current tough economic environment, and GECC's continuing high reliance on wholesale funding sources.

Excluding the potential for additional support from GE, we have always viewed GECC's hypothetical stand-alone credit profile (SACP) as being weaker than our rating assessment on GE; our current assessment is 'A', in contrast to the 'A+' we had indicated previously. GE has reaffirmed its support of GE Capital through completed and planned equity infusions into GE Capital totaling \$15 billion, coupled with a decision announced in September to reduce, at least temporarily, GECC's dividend payout to GE to 10% of GECC's net earnings from 40%.

GECC's large size compared with the rest of GE and the former's heavy ongoing funding requirements mean that there are limits to the further support that GE could provide to GECC. GECC's pretax earnings from continuing operations accounted for about half of GE's consolidated total earnings during 2005 through 2007, but management is now targeting a more balanced 30% contribution level.

With consolidated assets totaling \$631 billion on Sept. 30, 2009--approximately 70% commercial, 30% consumer--GECC is a premiere provider of credit services to small and middle-market companies and has a substantial position as a consumer lender. It has unparalleled product and customer diversification, and it is very diverse geographically, with 53% of the portfolio outside the U.S. The company operates through several business segments, each a major player in its primary market.

The stand-alone credit assessment also takes account of near-term severe earnings pressure caused by weakening general economic conditions. Despite its competitive strengths, GECC is still subject to the credit cycle. GECC's pretax income from continuing operations was down 55% in 2008 from 2007. GECC incurred a pretax loss of \$1.4 billion through the first three

quarters of 2009, partly because of various write-downs and impairment charges, as well as significant additions to credit-loss reserves.

Delinquencies and credit-related charge-offs have risen significantly in the past year, particularly in GECC's U.S. consumer portfolio and global consumer mortgage portfolio. Management has forecast full-year credit costs (including incremental additions to reserves) to total about \$9 billion (pretax) in 2009, about 2.4% of outstandings, compared with \$7.5 billion (1.85%) in 2008. GECC's credit-quality measures remain significantly better than those of the vast majority of its peers, and we expect them to remain so. Still, we believe there is some risk that credit performance could continue to deteriorate, particularly given the potential for a sharp increase in losses at GECC's commercial businesses, reflecting the steep economic downturn. In addition, we see pressure on the value of its real estate holdings and investment securities. Thus, we believe that subpar financial performance could well continue through 2010.

During the worst of the crisis, GECC, like all market participants, suffered from extremely difficult funding conditions stemming from severe turmoil in the capital markets. GECC had historically been highly dependent on commercial paper (CP) as a funding source, which is a particularly confidence-sensitive form of short-term borrowing. The company also had maintained aggressive financial leverage relative to its then 'A+' stand-alone credit profile (the current SACP is 'A'). However, since late 2008 the company has been pursuing a number of steps to reduce financial risk, including:

- Reducing GECC's reliance on CP. CP outstanding totaled \$72 billion on Dec. 31, 2008, down from more than \$100 billion in 2007. Management targeted a \$50 billion balance by year-end 2009 and has achieved this target ahead of schedule.
- Increasing liquidity available to provide backup for CP outstanding, including cash at GE and GECC and \$52 billion of committed bank lines.
- Increasing capital by temporarily reducing its dividend payout to the parent to 10% from 40% of GECC's net income.

GECC is also deleveraged through an equity infusion from GE totaling \$15 billion and significant shrinkage of GECC's asset base by slowing originations and selling assets.

Like other financial institutions, GECC's access to term unsecured debt on attractive terms was significantly constrained during the crisis. Although as of Sept. 30, 2009, GECC had \$69.3 billion of long-term debt maturing in the next 12 months, it has already refinanced much of this amount and it has considerable flexibility in the timing of term debt issuances. GECC is accelerating growth of deposits issued by its bank subsidiaries from a small base (\$36.3 billion on Sept. 30, 2009); yet the company is likely to remain predominantly wholesale funded for the foreseeable future, leaving it subject to volatile capital market conditions.

The stable outlook on GECC reflects the outlook on GE overall. We believe that GE's cash-generation capabilities remain fundamentally strong, even in the face of enormous global economic headwinds, and will result in growing cash balances from current levels during the next two years. We do not expect GE to benefit from any meaningful earnings or cash flow from GECC through 2010.

GE's commitment to maintaining very high credit quality, the still-solid prospects for many of its business segments (despite economic weakness), and the company's ample financial flexibility should continue to support our ratings and stable outlook.

However, we could reexamine our outlook if, for example, we came to expect that GECC would report significant losses for an extended period of time, if the company shifted its financial policies, or if strategic shifts in GE's portfolio of businesses were to jeopardize the company's excellent business risk profile.

# European Finance House Offshore Sharia Fund Assigned ‘AAf/S1+’ Fund Credit Quality And Volatility Ratings

LONDON (Standard & Poor’s) May 4, 2010--Standard & Poor’s Ratings Services said today that it assigned its ‘AAf’ fund credit quality and its ‘S1+’ fund volatility ratings to EFH Funds SCA SICAV-SIF - Liquidity Subfund (the “subfund”), a Luxembourg-domiciled U.S dollar-denominated liquidity fund, managed by European Finance House (EFH). This is the first Standard & Poor’s fund credit quality and fund volatility rating assigned to an offshore Islamic fund.

Fund credit quality ratings generally reflect our assessment of the level of protection against losses from credit defaults and are based on an analysis of the credit quality of the portfolio investments and the likelihood of counterparty defaults.

Fund volatility ratings generally reflect Standard & Poor’s view of the fund’s sensitivity to interest rate movements, credit risk, investment diversification or concentration, liquidity, leverage, and other factors.

The ratings reflect Standard & Poor’s analysis of the subfund’s credit quality and investment policies, its assessment of the subfund manager’s experience, and its view of the subfund’s expected sensitivity to changing market conditions, among other factors. The ‘AAf’ credit quality rating reflects our assessment that the subfund’s selection of portfolio holdings and counterparties provides very strong protection against losses from credit defaults. The ‘S1+’ volatility rating assigned to the subfund reflects our assessment that we view the subfund’s sensitivity to changing market conditions as extremely low. For a Sharia fund to be eligible for a fund credit quality rating, we look to see whether the Sharia fund has invested in rated Islamic financial instruments that share similarities with fixed-income securities.

The EFH Funds SCA SICAV-SIF - Liquidity Subfund is described in its offering document as an open-ended investment company with variable capital and organized as a Société d’Investissement A Capital Variable in the Grand Duchy of Luxembourg. The subfund’s investment advisor has indicated to us that it intends to primarily invest in “wakala” agreements with financial institutions approved by the firm’s Sharia Supervisory Committee.

“Wakala” agreements are typically agency contracts widely utilized by Islamic banks, whereby the fund’s depositor authorizes its agent to invest the funds in Sharia-compliant assets. This Islamic contract is largely used in Islamic finance between financial institutions and their clients, particularly in brokerage services, Islamic insurance (“takaful”), and funds management as an alternative to “mudaraba”. Mudaraba are typically investment contracts whereby the investor (“rab ul mal”) provides capital to another party (“mudarib”), which provides its expertise in order to invest in a Sharia-compliant business activity.

The subfund’s investment advisor has indicated to us that it expects the subfund (“muwakkil”) to invest in wakala contracts with specific Islamic financial institutions. We understand that the Islamic financial institutions act as the agent (“wakil”) of the subfund and invest a certain amount for a period of time in exchange for an expected profit payable on a monthly basis to the subfund. We understand that the subfund’s investment advisor intends to enter into wakala contracts of a maximum term period of one year (with a one-day call facility), with the aim to provide daily liquidity to investors and if necessary terminate the contract if the expected profit is lower than the one agreed at the beginning of the transaction.

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The subfund is managed by EFH, a London-based affiliate of Qatar Islamic Bank (QIB), its main shareholder. EFH benefits from its relationship with QIB to provide financial services to clients, including asset management. We understand that the same London-based management team will oversee the liquidity subfund's investments while also managing EFH's Global Sukuk Plus Fund that invests in the global sukuk market (Islamic bonds) and has approximately \$50 million assets under management.

The subfund's custody and administration services are described in the offering document for the subfund as being provided by Luxembourg-based The Bank of New York Mellon (Luxembourg) S.A., a wholly owned subsidiary of Bank of New York Mellon Corp. (AA-/Stable/A-1+).

Standard & Poor's fund credit quality ratings, identified by the 'f' subscript, are forward-looking opinions about the overall credit quality of a fixed-income fund's portfolio. Fund credit quality ratings range from 'AAAf' (extremely strong protection against losses from credit default) to 'CCCF' (extremely vulnerable to losses from credit defaults). Standard & Poor's fund volatility ratings, identified by the 'S' subscript, are forward-looking opinions about a fixed-income fund's sensitivity to changing market conditions, relative to a portfolio made up of government securities and denominated in the base currency of the fund. Volatility ratings range from 'S1+' (lowest sensitivity) to 'S6' (highest sensitivity).

Standard & Poor's reviews pertinent fund information and portfolio reports on a monthly basis as part of its surveillance process of its fund credit quality and volatility ratings.

# Using Fund Ratings As A Tool To Assess Credit And Market Risks In Sharia Funds

The economic boom in the Gulf Cooperation Council (GCC) region has fueled the emergence of Islamic finance in the international market in the past decade. Revenue growth in this region has particularly benefited the asset-management sector. The Middle East is by far the largest market for Sharia-compliant funds, but conventional players in Europe, South Africa, and the U.S. have also launched a number of funds that comply with Sharia law during past years, enhancing their product range to meet the specific requirements of Islamic investors seeking to invest in this asset class.

In 2008, Ernst & Young estimated that there were 500 Sharia funds, although the number is constantly growing. The number of product types remains limited, which Standard & Poor's Ratings Services believes is largely due to the nascent nature of Sharia funds. Funds also have to be invested in ways that are permitted under Islamic law. Sharia funds, unlike traditional bond funds, do not invest in conventional rated fixed-income securities because these are, by definition, financial instruments that accumulate interest and are therefore not considered Sharia-compliant.

In May 2010, we assigned our first 'AAf/S1+' fund credit quality and volatility ratings to a newly established Sharia fund--EFH Funds SCA SICAV-SIF-Liquidity Subfund, domiciled in Luxembourg and managed by European Finance House, the European financial arm of Qatar Islamic Bank. Islamic finance investors have shown an increasing interest in diversifying their investments from traditional Sharia-compliant financial instruments. They are starting to invest in Sharia-compliant mutual funds like the EFH Funds SCA SICAV-SIF-Liquidity Subfund and may look at Sharia fund ratings as a way to help them assess their credit- and market-risk exposure.

We see rating Sharia funds as a way to enhance credit-risk awareness in this asset class. Most Sharia funds are equity-, commodity-, or lease finance-based funds, but some of them, despite being invested in Islamic financial instruments, are similar to fixed-income funds.

## Islamic Law Requires Sharia Funds To Invest In Sharia-Compliant Investments

The fundamental principle of Islamic finance is that it prohibits interest-bearing investments, also called "riba." Sharia boards or other governance structures decide whether a transaction, instrument, or institution is compliant with Islamic law. Conventional fixed-income securities are, by definition, financial instruments that provide a steady return based on an interest rate, and would typically not be considered Sharia-compliant. Islamic financial instruments, by contrast, are structured to produce a profit instead of a fixed return tied to their face value. To comply with Sharia law, funds may only invest in Sharia-compliant assets.

It is generally understood in Islamic finance that, in theory, neither the principal nor the rate of profit can be guaranteed except for specific cases such as the unremunerated current accounts with financial institutions. The shareholder of a Sharia fund typically shares the risks and rewards of the investment. We understand that the funds are typically designed so that shareholders will see the value of their investment increase in proportion to the profit the fund produces. If the fund produces a loss, shareholders will usually have to bear the loss on a pro rata basis, unless it is due to management negligence or misconduct.

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### **Appropriate investments for Sharia funds**

Although we do not consider Sharia funds to be typical money-market funds, some of them can provide liquidity by investing in financial instruments or transactions that are similar in many ways to conventional money-market or fixed-income instruments.

#### *Wakala.*

Some Sharia funds invest in wakala, which are agency contracts that includes in their terms a fee for the expertise of the agent. We view wakala agreements as management mandates where the fund manager ("muwakkil") appoints a financial institution ("wakil") to invest a certain amount for a fixed period on its behalf. The muwakkil then receives a profit paid on a fixed schedule. Wakala may incorporate a liquidity feature to enable the fund manager to meet investors' redemptions. Wakala is one of the two main types of Islamic contracts widely used between financial institutions and their clients, particularly in brokerage services, Islamic insurance ("takaful"), and fund management.

#### *Sukuk and ijara.*

One of the most popular Sharia-compliant financial instruments is the sukuk, which is typically defined as a Sharia-compliant financial certificate tradable on the secondary market. Sukuks may be compared with bonds in many ways except that they do not bear interest. One of the most common structures for sukuk issuance is ijara, whereby the sukuk is structured around a pool of ijara transactions or a tangible asset being leased.

### **Types of Sharia funds**

Given the restrictive rules by which Sharia funds must abide, many of them are invested in equity, ijara, commodity, murabaha, or a combination of these types of assets.

In our view, equity funds are by far the leading asset class in Islamic funds. They are permitted to invest only in businesses that are deemed acceptable by Sharia boards. Although some of them may use a capital-protected strategy, equity funds are not eligible for a fund credit rating.

Ijara funds aim to lease out assets they purchase, such as real estate or equipment, to their end users. Ijara contracts are one of the few Islamic contracts that incorporate a fixed-income stream derived from the use of the underlying leased asset.

Another type of Sharia fund typically invests in commodities. Commodity murabaha funds are closed-end funds specifically set up to purchase commodities on behalf of clients and sell them back to these clients at an agreed margin of profit. This type of transaction can be compared with a fixed-rate loan, as the fund will typically pay to purchase the commodities, and therefore lend money to the shareholder at an agreed rate of profit. Murabaha transactions typically provide a fixed income stream to Islamic banks seeking a risk/return profile similar to interbank deposits. Their profit is often determined using an interest benchmark such as LIBOR.

Other Sharia funds are mixed investment funds investing in a combination of equity, commodities, and leased underlying investments.

### **Examining Sharia Funds More Closely Using Our Funds Criteria**

We offer three types of ratings for funds: fund credit quality ratings, fund volatility ratings, and principal stability fund ratings (PSFRs; also known as money-market fund ratings). When rating Sharia funds, we first consider what type of rating to assign. So far, Sharia funds have proved eligible for the first two types of ratings.

### **Our PSFR criteria effectively exclude Sharia funds**

PSFRs reflect our opinion of a fund's capacity to maintain a stable net asset value (NAV) and to limit exposure to principal losses due to credit risk. However, most Sharia funds we have seen to date are unlikely to meet our criteria for a PSFR regarding issuer credit quality, issuer diversification, and individual/portfolio maturity.

For example, money market funds that we currently rate 'AAAm' are invested in what we consider to be diversified portfolios, comprising high-credit-quality short-term money market instruments rated at least 'A-1', with a maximum weighted average portfolio maturity of 60 days. We assign PSFRs to stable NAV funds and accumulating NAV money-market funds. These ratings reflect our view of a fund's capacity to maintain principal stability and to limit exposure to principal losses due to credit risk. We expect that due to the current lack of eligible investments for Sharia funds, it would be difficult for most of these funds to meet our PSFR criteria. (For more information see "Principal Stability Fund Ratings Criteria Updated," published March 10, 2009, on RatingsDirect.)

### **Fund credit quality and fund volatility ratings are more likely to be assigned to certain types of Sharia funds**

Our fund credit quality and fund volatility ratings are not based on any explicit diversification criteria.

Our fund credit quality ratings reflect our evaluation of a fund's protection against losses from credit defaults (see "Fund Credit Quality Rating Criteria," published Feb. 2, 2007, on RatingsDirect). For a Sharia fund to be eligible for a fund credit quality rating, we look to see whether the Sharia fund has invested in rated Islamic financial instruments that share characteristics with fixed-income securities.

In addition to our fund credit quality ratings, we also assign fund volatility ratings to Sharia funds, which reflect our opinion of the fund's sensitivity to interest rate movements, credit risk, investment diversification or concentration, liquidity, leverage, and other factors. In our analysis, we assess the volatility of funds' monthly returns against government indices with different maturity bands. We believe that volatility ratings provide investors with a benchmark for risk and return comparisons. Our evaluation includes portfolio risk analysis, historical return analysis, and management assessment (see "Fund Volatility Rating Criteria," published Feb. 2, 2007, on RatingsDirect).

### **Assessing Counterparty And Investment Risk**

One of the key factors in assigning a fund credit quality rating to Sharia funds as fixed-income funds is our assessment of the creditworthiness of counterparties and investments.

### **Evaluating a fund's portfolio when assigning fund credit quality ratings**

We have assigned our fund credit ratings to various types of fixed-income funds or portfolios, including bond funds, local investment pools, and cash-enhanced funds. Under our rating criteria, sukuk funds will typically be eligible for a rating as long as we rate all the underlying instruments of the fund's portfolio. A maximum of 25% of the underlying assets may be rated by other rating agencies.

When assigning a fund credit quality rating, we evaluate the fund's portfolio credit risk and conduct a qualitative assessment of the fund management's experience, credit, and investment policies. Fund credit ratings reflect our view of a fund's overall credit quality and its exposure to credit risk. Likewise, our assessment of a Sharia fund reflects our view of the quality of management, the fund's investment strategy, and the creditworthiness of the investments held in its portfolio, such as sukuku. We also typically consider the counterparties with which the fund engages in market transactions--for example, wakala

agreements. In addition, when assessing specific contracts such as wakala agreements, we consider whether the fund would bear any additional cost if the contract terminated early.

### **Applying our existing funds criteria**

To evaluate a fund's credit risk using our existing criteria, we apply credit risk factors associated with each credit rating category and maturity bucket to the fund's percentage holdings. The credit risk factors are derived from our historical rating default and transition studies. The credit score obtained by the fund corresponds to a specific rating category. The final credit rating assigned to a fund takes into account our qualitative assessment of the fund management. Our ratings do not reflect our opinion on the fund's compliance with Islamic law.

Consequently, the ratings we would assign to Sharia funds would be based primarily on our view of the creditworthiness of Islamic counterparties and the ratings assigned to financial instruments in which they invest. We believe that credit risk associated with Islamic financial institutions bears unique features compared with conventional financial institutions. We have therefore developed a specific set of criteria to better reflect what we see as the various risks of operating within the principles of Islamic law.

### **Ratings On Islamic Financial Institutions Play A Role In Rating Sharia Funds**

Our fund credit quality ratings reflect our opinion on the level of protection a fund provides against losses due to credit defaults on the assets the fund holds. The creditworthiness of Islamic financial institutions to which a fund is exposed and ratings on Islamic instruments such as sukuk held by the fund play an important role in our assessment of the fund's overall credit quality.

### **Rating Islamic banks and Islamic instruments**

Broadly speaking, we apply the same methodology used to rate conventional banks to rate Islamic banks. However, we do take into account the specific features that may arise from operating in compliance with Sharia. Typically, for a financial institution, compliance with Sharia principles may, in our opinion, give rise to some specific risks.

### **Credit risk**

One of the principles of Islamic finance is that all the transactions have to be backed by a tangible asset, which means that Islamic banks tend to have more collateral than do their conventional counterparts. However, we understand that in some cases collateral foreclosure under a default scenario may be difficult or impossible. Indeed, for mortgage lending, although an Islamic bank is theoretically in a position to evict a customer from a property and resell it in the case of a default on the loan backed by the property, we understand this would generally be unlikely to happen owing to its "social responsibility." There are, however, instances when such a decision may be made by a bank and authorized by its Sharia board--notably when specific conditions were set out and agreed on before the conclusion of the transaction. In such cases, foreclosure may be easier than for conventional banks, as the property belongs to the Islamic bank under some Sharia-compliant structures.

In our view, a bank's credit risk can also be influenced by how its operations are funded. Under the Accounting and Auditing Organisation for Islamic Finance Institutions (AAOIFI) reporting standards, there is a separation between assets financed through equity and assets financed through profit-sharing investment accounts (PSIA). In the case of a default on some assets financed through PSIAs, the holders are supposed to share the losses.

Thus, we understand that funding a loan portfolio through PSIAs could be viewed as a

partial transfer of credit risk to PSIA holders under the AAOIFI's reporting standards. We believe that a loss could trigger some PSIA holders to withdraw their funds, which could translate into liquidity issues. We assume that Islamic banks would usually be inclined to support PSIA holders in the case of issues related to the credit quality of the underlying assets.

### **Market risk**

We have observed that Islamic banks largely escaped the first wave of the current financial crisis. We understand that this is partly because they did not invest in structured investment products; the majority of these are based on interest, which is forbidden in Sharia law. However, we do not think this means that they are not exposed to market risk. Indeed, we observe that their investment portfolios are generally composed of equities, sukuk, and real estate, which can be sources of market risk. We also see that many Islamic banks are exposed to margin risk that arises from their intermediation activity and the fact that some of their exposures, such as murabaha contracts, may be at fixed margins.

### **Funding and liquidity risk**

Some Islamic banks rely to a certain extent on PSIAs for funding. We understand the terms and conditions of PSIAs typically provide for depositors to be entitled to receive a share of the bank's profits, but also oblige them to bear potential losses pertaining to their investment in the bank. This profit-sharing principle--according to which investors and entrepreneurs must share the risks and rewards of a given venture--is core to Islamic finance. We believe that it may translate into a displaced commercial risk, however, and could result in a liquidity stress if PSIA holders decide to withdraw their deposits at maturity if the remuneration served by the bank is not in line with their expectations. We understand that Islamic banks have developed several layers of defense to manage this risk.

We have developed specific methodologies to rate Sharia-compliant instruments, given their nature. These apply mainly to sukuk and PSIAs. In our sukuk rating methodology, we distinguish among three types of sukuk from a credit rating perspective. These are:

- Sukuk with full credit enhancement mechanisms. The ratings are based on the rating on the entity providing these mechanisms;
- Sukuk with no credit enhancement mechanisms. We base our ratings on our assessment of the value and the performance of the underlying assets to the transaction under different stress scenarios; and
- Sukuk with partial credit enhancement mechanisms. The ratings are based on a combination of the two previous methodologies.

As far as PSIAs are concerned, due to their loss-absorbing nature, we do not generally rate them under our classic rating methodology as we see that a negative return is deemed as a default in the conventional world, but is permissible under the PSIAs' terms and conditions. Therefore, we have developed a specific methodology to address this unique characteristic; stability ratings. These ratings reflect our opinion about the expected stability, defined as sustainability and variability, of cash flows distributable to the PSIA holders of an Islamic bank.

### **The impact of the global financial crisis on Islamic banks has been varied**

We believe that most Islamic banks have, in general, been more resilient to the financial crisis than their conventional counterparts. However, some of them were particularly affected by the downturn in the housing and equity markets. Credit ratings on Islamic financial

institutions provide our assessment of the relative creditworthiness of these institutions.

Our ratings on Islamic financial institutions in the GCC region range from 'CCC-/Negative/C' for Bahrain-based Gulf Finance House to 'A/Stable/A-1' for Saudi-based Al Rajhi Bank. The outlooks for rated Islamic financial institutions in the region range from negative to stable, depending on their country of location.

#### RATINGS ON ISLAMIC FINANCIAL INSTITUTIONS IN THE GULF COOPERATION COUNCIL

	Country	Ratings
Albaraka Banking Group (B.S.C.)	Bahrain	BBB-/Stable/A-3
Al Rajhi Bank	Saudi Arabia	A/Stable/A-1
BEST RE	Tunisia	BBB+/Stable/--
Dubai Islamic Bank	United Arab Emirates	BBB-/Watch Neg/A-3
Dubai Islamic Insurance & Reinsurance Co. (Aman)	United Arab Emirates	BBB/Negative/--
Gulf Finance House	Bahrain	CCC-/Negative/C
Hannover ReTakaful B.S.C.	Bahrain	A/Stable/--
First Takaful Insurance Co.	Kuwait	BBB-/Stable/--
Islamic Development Bank	Saudi Arabia	AAA/Stable/A-1+
Kuwait Finance House	Kuwait	A-/Negative/A-2
Salama/Islamic Arab Insurance Co. (P.S.C.)	United Arab Emirates	BBB+/Stable/--
Sharjah Islamic Bank	United Arab Emirates	BBB/Stable/A-2
Takaful International Co. BSC	Bahrain	BBB/Stable/--
Takaful Re Ltd.	United Arab Emirates	BBB/Stable/--
Wethaq Takaful Insurance Co. K.S.C. (Closed)	Kuwait	BB/Negative/--

*Ratings are Standard & Poor's on April 30, 2010.*

#### Demand For Ratings On Sharia Funds Depends On The Expansion Of Islamic Finance

In our opinion, the growth in the number of credit and volatility ratings we assign to Sharia funds will depend on the levels of credit ratings assigned to Islamic financial institutions. We expect it will also be conditioned by further innovations from the Islamic finance sector, allowing it to offer a broader and more-liquid universe of rated investments to Sharia funds that are seeking to diversify their counterparty exposures and investments. Furthermore, we believe Islamic investors' risk tolerance and appetite for funds that combine Sharia-compliant investments with credit and market risk management may influence the demand for Sharia fund credit and volatility ratings.

# Analyzing Sharia-Compliant Takaful Insurance And Reinsurance Companies: Concepts And Considerations

Standard & Poor's Ratings Services is rating more and more insurance and reinsurance companies that operate under "takaful" (mutual burden sharing) principles, which help render their activities compliant with Islamic Sharia law. We therefore have to consider the practical implications for our analysis of this concept of insurance activity.

## Concepts Of Takaful And Our Analysis

Many concepts within takaful can largely remain outside our analysis, most notably the idea that the customer is less a policyholder paying a premium to buy a policy guaranteeing protection and more an entrepreneur sharing risks with other participants on a mutual basis while paying a donation to participate in any surplus on the takaful underwriting and investment funds after claims have been settled. Analytically, we remain unconcerned whether premiums need to be called "tabarru" (donation, contribution, or gift), or whether policyholders are called "participants". Similarly, we have no need to involve ourselves in any debate on compliance across the various schools of Sharia law, and it is not in our role as credit analysts to opine on the degree to which a given insurer or reinsurer avoids or falls foul of the ethical pitfalls of "riba" (usury), "gharar" (uncertainty), "maisir" (gambling), or involvement with activities deemed "haram" (prohibited by religion). (For further definitions of Islamic Finance terms, see "Glossary Of Islamic Finance Terms," published on Jan. 7, 2008, on RatingsDirect.)

## Impact of Islamic principles on accounts

Nevertheless, when the pursuit of Islamic commercial principles leads in our opinion to significant changes in the way an insurer presents its accounts, then we aim to understand the detail of what is happening. A brief glance at the report and accounts of almost any takaful operation will reveal that both the balance sheet and income statement are split to reflect the separate and sometimes divergent fortunes of the operating and shareholders' accounts, with the surpluses on each being separately available to policyholding participants on the one hand and to shareholders on the other.

A more detailed analysis of a variety of accounts prepared on a takaful basis also reveals a number of significant and sometimes complex features, particularly financial cross-flows between participants and shareholders. Indeed, it soon becomes clear that the various forms of takaful practiced can go well beyond the cooperative ("ta'awuni") insurance model commonly found in Saudi Arabia, with possibly the most widespread in the Middle East now being the so-called "hybrid" wakala – mudaraba model. Under this model, the takaful company as operator will levy "wakala" or agency fees against the various lines of business in the mutual operating fund, fees that are usually equal to some 15%-25% of gross written contributions (premiums). These wakala fees are intended to cover more or less exactly the routine operating costs of the company. Although technically a possibility, it is usually deemed unethical for a takaful insurer's Board of Directors to seek to generate a profit for shareholders by levying an artificially high level of wakala fees. However, it occasionally happens that a company will subsidize its policyholder-participants by levying a deliberately low level of wakala fee, although

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an inadvertently low fee cannot be "topped up" in arrears by a supplementary fee if actual expenses during the year prove higher than anticipated.

The second levy under the hybrid model is the "mudaraba" (profit and loss sharing trust) fee, which is charged as a form of management fee against either income or surplus on the takaful investment fund, but not against the separate investment portfolio that relates to shareholders' funds. By means of the mudaraba fee and the investment return on the company's capital, takaful company shareholders can expect to receive an acceptable return on their investment in a good year, while participant policyholders can expect to obtain not only Sharia-compliant, mutualistic insurance protection, but also a potential share in any surplus on the takaful operating account, a share which may be received as cash or, more commonly, in the form of a discount on renewal of the insurance cover.

### **What happens if the takaful funds incur an overall deficit?**

In our view, the crucial ambiguity that can arise with takaful only becomes apparent when the following question is posed: "What happens if the takaful funds incur an overall deficit?" The usual expectation is that the takaful operator will debit the shareholders' fund and extend an interest free loan, the "qard hassan" (benevolent loan) to the mutual operating account in order to reverse the shortfall, with this loan subsequently being repaid from future operating account profits. However, unless the takaful operator has specifically indicated in advance that it will provide a qard hassan from the shareholder account in the event of an operating account deficit--something upon which a competent Sharia Board would normally insist--then such a loan remains an implicitly discretionary undertaking under the terms of the takaful agreement, as, technically, under a takaful insurance contract it is the participant policyholders and not the shareholders who are mutually responsible to ensure that all claims are paid.

This feature of a takaful mode of operation therefore raises the possibility of a supplementary premium call being made against policyholders. This is occasionally seen with some French mutuals. In the event of major losses, the possibility of a very large supplementary claim being made against policyholder participants could even arise, more akin to what may periodically occur in the international marine mutual (protection and indemnity) sector. We believe a result of this placing of the onus on policyholder-participants rather than on shareholders to pay claims could be that large supplementary calls are made against policyholders at exactly the same time as shareholders are withdrawing their still-intact equity from the company.

### **Overcoming potential hurdles**

Our approach to these potential issues is to discuss them with the takaful operations that we rate, with a view to ascertaining whether the takaful managers have indeed mandated in advance to provide a qard hassan from the shareholders' funds in the event of a deficit on the operating account. Moreover, we typically take a level of comfort from the fact that we would generally expect the Sharia Board that exists within each takaful company, and also the local insurance regulators, to exert pressure to ensure that a qard hassan is extended whenever needed.

### **Concerns with the takaful model**

If we do have questions regarding the takaful model, these tend to center less around hypothetical issues and more around conventional analytical problems. For example, if the wakala fee is levied as a percentage of the gross premiums--or contributions--written, is there

not a danger of moral hazard? Will the takaful operator be encouraged to maximize the income of shareholders by writing more business than may be prudent, and if too much risk is written, will the company then risk becoming dependent on the willingness and ability of its reinsurers to provide suitable protection? Similarly, will a legitimate desire to avoid noncompliant investments constrain a takaful operator's ability to prudently diversify its asset portfolio or, more significantly, will Sharia compliance encourage over-exposure to potentially volatile equity markets, or volatile and often illiquid property investments?

## The Nine Elements Of Our Analysis

THE NINE ELEMENTS OF STANDARD & POOR'S INSURANCE ANALYTICAL PROCESS	
1	Economic And Industry Risk: sovereign, regulatory, legal, accounting, and other macroeconomic and market factors
2	Competitive Position: microeconomic view of the company's competitive strengths and weaknesses
3	Management And Corporate Strategy: analysis of the quality of management and the appropriateness of strategy
4	Enterprise Risk Management: a holistic assessment of the company's risk management practices and methodologies
5	Operating Performance: analysis of underwriting, investment, and overall earnings performance
6	Investments: an assessment of the nature and appropriateness of the insurer's investment assets
7	Liquidity: an analysis of cash flows and committed bank funding, as well as of the inherent liquidity of investment assets
8	Capitalization: amount and quality of capital, reserve adequacy, reinsurance protection, and risk-based capital modelling
9	Financial Flexibility: the ability of the rated entity to raise new cash or capital relative to the level of possible needs

We believe that distinct issues do therefore arise in the analysis and rating of takaful and retakaful companies. However, we believe that all of these issues can typically be addressed from within the standard analytical "template" that we apply in the interests of consistency to the analysis of all rated insurers and reinsurers around the world. In essence, this template comprises the nine elements of analysis listed in the table above. When applied to a takaful company, our analysis would usually still include the basic factors suggested in the table, but our assessment will normally also take into account the specific issues relating to a takaful mode of operation, as follows:

### 1. Economic And Industry Risk.

In addition to a standard survey of sovereign, legal, regulatory, fiscal, and other macroeconomic factors affecting the country or region in which the rated takaful company operates, we will seek to ascertain the degree to which the local insurance regulators have created surveillance standards that are specific to takaful, as is the case in Bahrain, for example, and will also talk with local accountants, brokers, and other insurance practitioners to clarify the degree to which takaful concepts and accounting are properly understood. If the industry infrastructure in which the takaful company operates is deemed robust, prudent, and supportive, then clearly this will provide us with greater comfort concerning the rated entity's likely prospects.

### 2. Competitive Position.

Our particular question is to what extent will a takaful mode of operation constitute a differentiating competitive strength for an insurer, or whether explicitly takaful procedures may inhibit business growth into, for example, commercial lines of business, and possibly restrict the company to a niche role in retail markets?

### **3. Management And Corporate Strategy.**

We believe that quality of management is key for all companies. However, as so many takaful insurers are of relatively recent establishment, the business acumen and contacts of the senior management team as well as their technical expertise can often prove vital in giving the new company a strong start in the marketplace. Naturally in our view, an effective Sharia Board as a complement to executive management can also enhance the status and credibility of a takaful company.

### **4. Enterprise Risk Management (ERM).**

Holistic ERM across all areas of the company is something that we believe is common to most successful insurance businesses, irrespective of its structure or mode of operation. In the context of takaful companies, we would typically expect to assess whether there is a strong management team, which aims to ensure that Sharia compliance, ERM, and appropriate corporate governance are all pursued with equal vigour.

### **5. Operating Performance.**

We separately assess the underwriting and investment performance of insurers, and generally expect higher-rated companies to be proficient in both activities, displaying sufficient overall net income to prove the success of management's actions over the year. However, when undertaking peer group comparisons of performance, we typically take account of the fact that a takaful company's underwriting and investment performance may to some extent be reduced by the levying of the wakala and mudaraba fees. However, once the operating and shareholder accounts are added together, the bottom line level of combined net income will be unaffected as the fees debited to the operating accounts then return to the income statement as a credit to the shareholder account.

### **6. Investments.**

At takaful companies, we usually find significant market risk in the form of equity and property investments, which will be a concern unless the company has a sufficiently strong capital base to support the periodic mark-to-market price volatility of such investments. As the sophistication and availability of Sharia compliant banking and capital market products increases, we would expect to see much more use of cash placements with Islamic banks, and investments in sukuk-type bonds and funds.

### **7. Liquidity.**

Rarely a problem for solvent insurers, we nonetheless expect to see sound cash flows, a high degree of "marketability" of investment assets and, ideally, access to friendly banks for any short-term funding requirements.

### **8. Capitalization.**

Our assessment of "capitalization" encompasses allied but separate reviews of quantity of capital, quality of capital, reserving, reinsurance, as well as risk-based capital modeling. As long as we have been able to conclude that the totality of shareholders' funds will under all circumstances be made available to support deficits on the takaful operating accounts, then our capital analysis of a takaful company differs little to that of a conventional insurer or reinsurer, save that we would add any surplus or deficit on the takaful fund to shareholders' funds when calculating the total equity base.

Quality of capital is usually good as Sharia financial principles will tend to discourage any major use of long-term subordinated or hybrid debt capital. Reserving, meanwhile, tends to be appropriate to best estimate as management has little reason to under- or over-state current bonuses or discounts to today's participants or shareholders by under- or over-reserving against outstanding liabilities, such that next year's participants risk suffering the burden--or reap the deferred rewards--of prior-year miscalculations. Besides, the independent Sharia Board with, ideally, the technical assistance of external consulting actuaries, is there to help ensure equitable treatment.

Finally, as regards reinsurance, we would anticipate that a takaful insurer will prefer to use Sharia-compliant retakaful protection. However, given that an insurer's reinsurance protection can often prove crucial in enabling proper payment of large or unexpectedly frequent losses, we believe that the strongest takaful companies will base their selection of reinsurers primarily on financial strength, and only secondarily on considerations of religious compliance. We understand Sharia law recognizes that in the event of necessity ("darura"), Muslims may set aside compliance in the interests of security, which may enable such decisions to be made.

### **9. Financial Flexibility.**

How likely is it that additional liquidity or solvency will be required, and how likely is it that the insurer will be able to raise the cash or capital needed? The greater the ability to raise additional resource relative to needs, the higher our sub-assessment of financial flexibility. For a takaful company, the most likely sources of balance sheet support are increased use of reinsurance protection, a qard hassan loan from shareholders, a capital increase by the shareholders, or Sharia-compliant funding from banks or the capital markets.

In conclusion, we do not regard takaful or retakaful companies as radically different in analytical terms to conventional insurance or reinsurance, and we see no particular need for separate criteria or methodologies. However, we believe that there are specific features and demands of a Sharia-compliant mode of operation that need to be taken into account in our analysis. This normally takes the form of largely qualitative adjustments in the way we interpret the results of our standard analysis.



## S&P Announcement: Standard & Poor's Voted Best Takaful Ratings Agency

LONDON (Standard & Poor's) July 2, 2009--For the second consecutive year, Standard & Poor's Ratings Services today announced that it has been voted "Best Takaful Ratings Company" at the International Takaful Awards 2009. The accolade, presented during an awards ceremony at The 3rd International Takaful Summit 2009 in London, acknowledges our commitment to supporting the development of the Islamic insurance industry.

We published our first Takaful rating in 1997 and we remain the leading rating agency for Islamic insurers, with eight ratings on Takaful and Retakaful firms across Africa, the Middle East, and Asia--more than any other global agency. During 2008, we published updated guidance on our approach to rating Islamic insurers and assigned new ratings to Bahraini-based composite insurer Takaful International Co. BSC, Kuwait-based insurer Wethaq Takaful Insurance Co. K.S.C., and Dubai-based insurer Dubai Islamic Insurance & Reinsurance Co. (Aman).

"We are thrilled to be recognized by the Islamic finance community for our continuing support of the Shariah-compliant risk-management industry, which is driving increased acceptance and understanding of the Takaful business model," said Yann Le Pallec, managing director of Standard & Poor's. "We continue to experience strong demand for new ratings from both Islamic and traditional insurers worldwide."

"Having grown from a niche product servicing limited demand, Islamic insurance has reached a critical mass in the past five years and is now firmly established within the global risk management markets," said Kevin Willis, credit analyst at Standard & Poor's. "The potential for growth is immense, with many consumers switching from conventional insurance or entering the Takaful market for the first time."

The International Takaful Awards 2009 are an initiative of the Middle East Business Forum and Afkar Consulting. Winners were selected from a pool of nominees by a panel of Shariah judges, lawyers, journalists, and practitioners from leading Islamic insurance firms worldwide.

To download a copy of "Islamic Finance Outlook 2009," our latest annual compendium of topical research, commentary, and analysis on almost 40 rated Islamic insurers, sukuk issues, and issuers, please visit [www.gcc.standardandpoors.com](http://www.gcc.standardandpoors.com).

### STANDARD & POOR'S TAKAFUL AND RETAKAFUL RATINGS

	Country	Ratings
B.E.S.T. Reinsurance Co.	Tunisia	BBB+/Stable/--
Dubai Islamic Insurance & Reinsurance Co. (Aman)	UAE	BBB/Negative/--
Hannover ReTakaful B.S.C.	Bahrain	A/Stable/--
Salama/Islamic Arab Insurance Co. (P.S.C.)	UAE	BBB+/Stable/--
Takaful International Co. BSC	Bahrain	BBB/Stable/--
Takaful Re Ltd.	UAE	BBB/Stable/--
Tokio Marine Retakaful Pte. Ltd.	Singapore	AA/Stable/--
Wethaq Takaful Insurance Co. K.S.C. (Closed)	Kuwait	BBB-/Watch Neg/--
<i>Ratings correct at July 2, 2009.</i>		

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# Dubai Islamic Bank

## Major Rating Factors

### Strengths:

- Adequate liquidity.
- Good commercial position.
- High systemic importance.

### Weaknesses:

- Weakened operating environment.
- High exposure to the domestic real estate sector and Dubai government-related entities.
- Below-average asset quality and profitability.

## Rationale

The ratings on Dubai Islamic Bank (DIB) reflect the bank's good commercial position, adequate liquidity, and high systemic importance. Negative rating factors include the bank's weakened operating environment, high exposure to the domestic real estate sector and Dubai government-related entities (GREs), which we believe will weaken the bank's already below-average asset quality and profitability metrics.

We classify DIB as a highly systemically important bank in the United Arab Emirates, which we categorize as "interventionist" toward its banking system. With total assets of UAE dirham (AED) 84.3 billion on Dec. 31, 2009, DIB controls a market share of about 8% of total domestic deposits and plays an important role in the financing of the economy. Therefore, the long-term rating on DIB is two notches above its stand-alone credit profile (SACP) to reflect our expectation of moderately high likelihood of extraordinary support from the UAE authorities in case of need.

DIB is heavily exposed to the real estate sector--its historical core competence--representing about 40% of the bank's financing portfolio on Dec. 31, 2009. Standard & Poor's Ratings Services views this exposure, along with the bank's significant exposure to Dubai GREs--about 30% of total loans--as the two main sources of risks. These exposures have significantly weakened DIB's SACP in light of the deterioration in the bank's operating environment. DIB's nonperforming loans (NPLs) ratio increased to 6.0% at year-end 2009, while coverage of NPLs by loan loss reserves--62.7% on the same date--is somewhat low and only partly explained by the NPL's high level of collateral. Taking into account past due but not impaired loans would increase the NPL ratio to 13.0% and decrease the coverage ratio to 28.9%.

DIB's exposure to the stock market is another source of risk. The bank reported a negative AED724 million in revaluation reserves on Dec. 31, 2009. DIB's 43% stake in Deyaar Development P.J.S.C. (not rated) is another source of risk. The sharp fall in Deyaar's share price is not reflected in DIB's financials because it is accounted for as an "investment in associate."

DIB's funding profile is adequate. Its loan-to-deposit ratio of 80.8% at year-end 2009 is significantly lower than for most peers that we rate. The bank's liquidity is adequate, with 16.8% of assets placed in liquid forms on the same date. The bank has a large portfolio of sukuk that it believes it can liquidate or repo in case of need. DIB's capitalization is barely adequate for the bank's risk profile.

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## Outlook

The negative outlook reflects the weakened operating environment and its expected impacts on DIB's financial profile. Under our base case scenario, we expect DIB's financial profile to remain in line with the current ratings. However, if the operating environment continues to worsen and the bank's financial profile, particularly asset quality and financial performance, are more affected than we expected, the ratings would come under downward pressure. On the other hand, we could revise the outlook to stable if operating environment pressure eases, the bank demonstrates a superior resilience to current market conditions, or if it improves its financial profile substantially.

## Profile: One Of The World's Largest Islamic Banks

DIB is one of the foremost Islamic banks in the world. Thanks to its strong brand and solid reputation, DIB's market position in the UAE Islamic finance industry is unparalleled. DIB captures a market share of about 8% in domestic deposits. The bank serves about 900,000 individual customers through a network of about 50 branches. DIB competes head on not only with domestic and regional Islamic banks, but also with conventional contenders across the UAE and the Gulf region. In January 2009, a consortium that DIB led acquired a controlling stake in Jordan-based Industrial Development Bank through a capital increase completed via a private placement of \$100 million--with DIB contributing \$40 million. The bank was subsequently renamed Jordan Dubai Islamic Bank (JDIB, not rated) and is being converted into an Islamic bank. DIB has management control of the bank, and will account for JDIB as an associate in its accounts. We view DIB's international expansion as somewhat risky but not excessive compared to the bank's capital base. Standard & Poor's expects DIB's presence outside its core market to remain relatively limited in the foreseeable future.

## Support And Ownership: A Positive Rating Factor

The long-term rating on DIB is two notches above the bank's SACP to reflect our expectation of strong likelihood of extraordinary government support in case of need. This is supported by DIB's status as a highly systemically important bank in a country where authorities are deemed interventionist toward their banking sector.

DIB's key shareholders are the Dubai government, which holds 29.8% through the Investment Corporation of Dubai (ICD). The UAE federal government has a 4.3% stake through the General Pensions And Social Security Authority. Five of the nine members of DIB's board of directors represent, directly or indirectly, the government of Dubai, namely: the Director General of The Ruler Court and the CEO of ICD; his deputy; the Chief of Group Audit and Risk Management of Dubai Holding; the CFO of Dubai Office; and The Chairman and Founder of the Bin Zayed Group. Other shareholders include prominent families, but none with a stake higher than 10%. We do not expect government ownership to reduce in the foreseeable future.

## Strategy: Continued Focus On Preserving The Bank's Financial Profile Amid The Turbulent Environment

DIB aims to continue with its strategy implemented in 2009 as a result of the shift in its operating environment. The bank's main objective is to preserve its financial profile amid the sharp correction of the real estate sector and the uncertainty about the restructuring of Dubai World and about other Dubai-based GREs. The bank's main strategic objectives include:

- Maintaining liquidity at a comfortable level: The bank plans to grow its loan portfolio only moderately in 2010 and to continue opening additional branches to attract deposits. DIB's liquidity profile remains adequate in our opinion. The bank maintains a large

- portfolio of sukuk that it can use as a source of emergency liquidity in case of need.
- Enhancing profitability: DIB is focusing on fees and commission income and repricing of the loan book to maintain margin. Standard & Poor's sees this objective as challenging because price competition to attract deposits has increased sharply in the overbanked UAE market.
  - Keeping capitalization at current levels: The bank intends to keep a relatively conservative dividend payout policy and to resort to shareholders to raise capital to maintain the same level of capitalization.

DIB also plans to continue diversifying its business geographically in other Middle Eastern countries, but gradually over the medium term. We do not expect the bank to make any significant acquisitions in 2010 because of the less supportive economic environment that is straining free capital.

### **Risk Profile And Management: Risk Management Tools Are Improving**

DIB's risk profile is dominated by high direct and indirect exposure to the real estate sector and Dubai GREs. The asset-backing principle behind the bank's Sharia compliance partly mitigates this risk, however. DIB's exposure to profit rate risk is limited because the bank uses profit rate swaps. Exposure to foreign exchange risk is also low because the bank has limited open positions in foreign currencies and uses foreign exchange contracts to reduce its risk. DIB carries some significant exposure to the local real estate and equity market. The bank's funding profile is above average and liquidity is adequate.

#### **Enterprise risk management: Weak**

Standard & Poor's deems DIB's enterprise risk management (ERM) as weak. The bank has an independent division in charge of risk management, under a chief risk officer reporting to the CEO and with access to the board. The bank is in the process of implementing new tools for the management of risks including a new rating system. The decision-making process is highly centralized at DIB.

#### **Operational risk: Fraud cases call for more stringent controls**

DIB was the victim of some cases of fraud in the past, including one the bank discovered in July 2008. For us, this raises concerns about the bank's control and corporate governance. Some top executives of the bank have been accused of wrongdoing. At the same time, the bank acted promptly to seize the exposure's collateral, which comprises plots of land in Dubai. Since then, we understand that DIB has extensively audited its portfolio to ensure that such a scenario doesn't happen again in the future. The bank has also reinforced its compliance team, which now has direct access to the board of directors.

#### **Credit risk: Real estate and GRE exposure are the main source of risk**

DIB's loan leverage is comparable with that of peers at 59.2% at year-end 2009. The bank carries high direct and indirect exposure to the UAE real estate sector--about 40% of total loans at year-end 2009--making DIB vulnerable to the current correction. The fraud case discovered in 2008, along with the current real estate correction, resulted in a sharp increase in DIB's nonperforming loans that reached about 6.0% of the bank's total loans at year-end 2009. NPLs coverage by loan loss provisions remains somewhat low in our opinion at 62.7% on the same date and is only partly explained by the collateral attached to this exposure. Taking into account past due but not impaired loans would have resulted in weaker asset quality indicators for DIB, with the NPL ratio reaching 13.0% and the coverage ratio reaching 28.9% at year-end 2009. The risk profile of DIB's real estate exposure--from

relatively low risk to relatively highest risk--can be classified as following:

- Mortgage lending portfolio to UAE nationals (AED1.5 billion at year-end 2009) typically to government employees with salary assignments;
- Freehold mortgage portfolio mainly to expatriates (AED2.5 billion at year-end 2009) in light of the current reduction of expatriate staff by some real estate developers and financial institutions;
- Income-generating properties that DIB has financed (AED7.0 billion at year-end 2009) in light of the drop in rental prices. We understand that DIB has restructured a large portion of this portfolio to realign loan repayments with the new cash flows; and
- Land murabaha (AED3.5 billion at year-end 2009) made for speculative purposes by some high-net-worth individuals (local and regional). We understand from DIB that these loans were initially granted with very conservative loan to value (about 50% on average) but that the price of land subsequently had declined sharply. We understand from DIB that it has restructured some of these loans mainly by lengthening the maturities, expecting customers to divest when market conditions improve.

DIB is also significantly exposed to Dubai World and other Dubai-based GREs, which represents about 30% of the bank's total loan portfolio--some of these exposures may also be classified as real estate exposures. The restructuring of Dubai World is raising significant challenges for DIB's asset quality, which could weaken further if other Dubai-based GREs need to be restructured. Under our base case scenario, we expect DIB's profitability to remain weak in 2010 as a result of additional provisioning needs.

Single-name concentration in DIB's portfolio is comparable with peers', with the top 20 funded exposures representing about one-third of total exposures and 1.7x reported equity at year-end 2009. Finally, DIB has a sukuk portfolio representing 10.8% of total assets at year-end 2009 and concentrated mainly on a few GREs and some regional names including financial institutions.

#### **Market risk: Limited exposure to margin and foreign currency risks**

DIB's exposure to margin risk is limited thanks to the use of profit rate swaps. The bank's exposure to foreign currency risk is also low because the bank keeps small open positions and uses foreign exchange contracts to cover its exposure. The bank carries some direct exposures to real estate through a portfolio of investment properties, including mainly land and other real estate in the UAE, amounting to AED2.0 billion at year-end 2009. Finally, DIB has an equity portfolio made up of shares, private equity, and investment funds--accounting for AED6.6 billion--concentrated on a few names operating in real estate and financial services. A large portion of this portfolio is accounted for as investment in associates (AED4.3 billion on Dec. 31, 2009) and is not revalued at market prices. We view this practice negatively because it could result in potential write-downs in the future. The bank classifies the remaining as either as available for sale--with unrealized losses of AED724 million on Dec. 31, 2009--or as trading investments.

#### **Funding and liquidity risk: Adequate profile**

DIB's liquidity is adequate in our opinion, with about 16.8% of assets placed in liquid forms at year-end 2009. The bank succeeded in attracting additional deposits and has reduced its loan growth in 2009. As a result, its loan to deposit ratio compares favorably with most peers' at 80.8% at year-end 2009. DIB has also a large portfolio of sukuk (AED9.3 billion or 11.0% of assets at year-end 2009) that it can use as a source of emergency liquidity if needed. Contractual maturity mismatches are substantial but the relatively high stability of DIB's

deposits is a mitigant. This stability was confirmed during the past 12 months despite the stressed operating environment. Moreover, in 2007, the bank issued a \$750 million five-year sukuk maturing in 2012.

DIB's deposit base remains, however, concentrated with the top 20 depositors contributing to about one-quarter of total deposits. DIB received AED3.4 billion from the UAE's Ministry of Finance under the support package the government put in place in 2008. The bank converted this deposit into a Tier 2 capital instrument--under the wakala structure.

### **Profitability: Likely To Remain Weak**

DIB's core profitability is adequate, with a ratio of net operating income before provisions to revenues of 60% in 2009. The bank enjoys an adequate margin of 3.3% and good efficiency, with a ratio of noninterest expenses to total revenues of 39.9% during the same period. However, Standard & Poor's believes that the bank's cost of risk is likely to remain high in 2010, and will largely depend on the real estate sector and how the Dubai World restructuring is carried out and whether the financial problems it experienced will spread to other Dubai-based GREs. Under our base case scenario for 2010, we expect DIB's profitability to remain at the same level of 2009 or decline slightly. We do not exclude the scenario where DIB will show losses in 2010 if the restructuring of Dubai World results in higher losses or if other Dubai-based GREs become affected. Finally, DIB's core income-generating capacity is likely to decline slightly in 2010 given our expectations of lower growth of the loan portfolio and higher cost of funding. Market-related income is also set to decline and potentially be negative if DIB decides to take an impairment charge as a result of the decline in the market value of its associates and particularly Deyaar. On the other hand, if the Dubai World restructuring is resolved with limited financial impacts, the operating environment improves, and the financial situation of other Dubai-based GREs doesn't require additional provisions, DIB's profitability could recover earlier than expected.

### **Capital: Barely Adequate**

DIB's capitalization is barely adequate given the bank's high exposure to the real estate sector and Dubai GREs. The ratio of ATE to assets reached 10.0% at year-end 2009. We estimate that our risk-adjusted capital (RAC) ratio was 5.9% on Sept. 30, 2009, significantly lower than the bank's capital adequacy ratio given our higher risk charges across the board, especially for DIB's equity portfolio and corporate exposure to the real estate sector. We also apply capital charges for DIB's geographic and single-name concentration. Mitigating factors are the shrinkage in the bank's assets, and our expectations that DIB's dividend policy will be conservative in the foreseeable future. DIB plans to raise additional capital in the near future to finance likely growth of its risk assets and maintain its capital level. No specific details have been announced, however.

Table 1: DUBAI ISLAMIC BANK ASSET QUALITY, FUNDING, AND LIQUIDITY RATIOS

%	--Year-ended Dec. 31 --				
	2009	2008	2007	2006	2005
Gross nonperforming assets/customer loans plus other real estate owned	6.0	4.1	4.0	4.7	4.3
Net nonperforming assets/customer loans plus other real estate owned	2.3	1.9	1.4	1.8	1.3
Loan loss reserves/gross nonperforming assets	62.7	55.9	66.8	62.2	70.4
Loan loss reserves/customer loans	3.8	2.3	2.7	2.9	3.0
New loan loss provisions/average customer loans	1.6	1.1	0.9	0.3	N/A
Net charge-offs/average customer loans	(0.2)	(0.2)	(0.1)	0.0	N/A
Customer deposits/funding base	89.4	91.6	92.9	91.1	89.1
Total loans/customer deposits	80.8	81.3	63.9	63.7	83.0
Total loans/customer deposits plus long-term funds	65.4	69.3	53.0	54.9	75.7
Customer loans (net)/assets (adjusted)	59.2	62.1	48.1	45.8	62.6

N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

Table 2: DUBAI ISLAMIC BANK PROFITABILITY RATIOS

%	--Year-ended Dec. 31 --				
	2009	2008	2007	2006	2005
Net interest income/average earning assets	3.3	3.1	2.3	2.2	N/A
Net interest income/revenues	68.8	64.3	40.3	37.5	37.2
Fee income/revenues	19.2	21.5	19.1	30.9	21.7
Market-sensitive income/revenues	5.9	7.8	31.7	26.8	35.9
Personnel expense/revenues	23.9	25.3	23.5	22.6	18.9
Noninterest expenses/revenues	39.9	40.6	40.8	41.1	32.0
New loan loss provisions/revenues	24.1	14.9	8.2	2.7	8.0
Net operating income before loan loss provisions/loan loss provisions	249.6	398.0	724.1	2,171.4	852.1
Net operating income after loan loss provisions/revenues	36.0	44.4	51.0	56.2	60.0
Pretax profit/revenues	35.9	44.4	67.7	56.2	60.0
Tax/pretax profit	0.6	(0.1)	(0.6)	0.4	0.3
Core earnings/revenues	35.8	44.5	N/A	56.0	59.8
Core earnings/average adjusted assets	1.4	1.8	N/A	2.9	N/A
Noninterest expenses/average adjusted assets	1.6	1.7	2.0	2.2	N/A
Core earnings/average risk-weighted assets	1.6	2.1	N/A	4.6	4.1
Core earnings/average adjusted common equity	13.7	18.1	N/A	30.7	33.2
Pretax profit/average common equity (%)	13.8	16.2	28.1	30.2	N/A

N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

Table 3: DUBAI ISLAMIC BANK CAPITAL RATIOS

%	--Year-ended Dec. 31 --				
	2009	2008	2007	2006	2005
Adjusted common equity/risk assets (%)	12.5	11.0	12.6	16.6	12.2
Tier 1 capital ratio	12.1	11.1	13.1	15.6	11.9
Adjusted total equity/adjusted assets	10.0	9.9	9.9	10.9	7.4
Adjusted total equity/managed assets	10.0	9.9	9.9	10.8	7.4
Adjusted total equity plus loan loss reserves (specific)/customer loans (gross)	20.0	17.8	22.6	25.9	14.6
Common dividend payout ratio	59.5	55.4	47.9	62.8	28.2

N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

Table 4: DUBAI ISLAMIC BANK SUMMARY BALANCE SHEET

--Year-ended Dec. 31 --					
Mil. AED	2009	2008	2007	2006	2005
<b>Assets</b>					
Cash and money market instruments	14,168.8	9,810.2	22,381.1	18,510.2	9,653.1
Securities	13,759.0	15,765.3	14,761.2	12,357.4	4,725.2
Trading securities (marked to market)	128.6	322.1	820.8	1,069.2	747.7
Nontrading securities	13,630.4	15,443.2	13,940.3	11,288.2	3,977.5
Customer loans (gross)	51,873.2	53,904.2	41,659.5	30,399.5	27,727.8
Loan loss reserves	1,948.3	1,245.2	1,124.7	881.2	841.9
Customer loans (net)	49,924.9	52,659.0	40,534.8	29,518.3	26,885.9
Earning assets	68,189.5	73,151.1	73,896.1	58,155.4	38,939.9
Equity interests/participations (nonfinancial)	3,769.9	3,765.4	3,628.7	972.3	86.6
Investments in unconsolidated subsidiaries (financial companies)	525.3	416.2	112.9	78.1	0.0
Intangibles (nonservicing)	34.5	N.A.	36.9	36.9	42.3
Fixed assets	657.8	668.8	630.7	495.6	401.8
Accrued receivables	985.7	1,164.0	975.2	971.3	828.0
All other assets	478.4	507.7	1,298.5	1,493.8	375.4
Total assets	84,304.3	84,756.6	84,359.9	64,433.9	42,998.3
Intangibles (nonservicing)	34.5	0.0	36.9	36.9	42.3
Adjusted assets	84,269.8	84,756.6	84,323.0	64,397.0	42,956.0
<b>Liabilities</b>					
Total deposits	65,644.6	69,659.8	67,416.9	52,382.4	37,491.3
Noncore deposits	1,449.1	3,331.1	2,241.3	4,649.9	4,099.4
Core/customer deposits	64,195.5	66,328.7	65,175.6	47,732.5	33,392.0
Other borrowings	6,167.6	2,754.8	2,754.8	0.0	0.0
Other liabilities	3,511.3	3,592.7	3,523.1	4,403.3	2,266.1
Total liabilities	75,323.5	76,007.2	73,694.8	56,785.7	39,757.4
Total equity	8,980.8	8,749.4	10,665.1	7,648.3	3,240.9
Minority interest-equity	4.9	0.1	250.8	287.1	121.6
Common shareholders' equity (reported)	8,975.9	8,749.3	10,414.3	7,361.2	3,119.2
Share capital and surplus	3,617.5	3,445.4	2,996.0	2,800.0	1,500.0
Revaluation reserve	(723.7)	(888.7)	1,006.6	544.6	0.0
Retained profits	822.2	886.1	1,701.5	43.2	5.5
Other equity	0.0	0.0	0.0	0.0	(8.2)
Total liabilities and equity	84,304.3	84,756.6	84,359.9	64,433.9	42,998.3
N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.					

Table 5: DUBAI ISLAMIC BANK EQUITY RECONCILIATION TABLE

--Year-ended Dec. 31 --					
Mil. AED	2009	2008	2007	2006	2005
Common shareholders' equity (reported)	8,975.9	8,749.3	10,414.3	7,361.2	3,119.2
Plus minority interest (equity)	4.9	0.1	250.8	287.1	121.6
Minus dividends (not yet distributed)	(718.2)	(860.5)	(1,198.4)	0.0	0.0
Minus revaluation reserves	723.7	888.7	(1,006.6)	(544.6)	0.0
Minus nonservicing intangibles	(34.5)	0.0	(36.9)	(36.9)	(42.3)
Minus interest-only strips (net)	0.0	0.0	0.0	0.0	0.0
Minus tax loss carryforwards	0.0	0.0	0.0	0.0	0.0
Minus postretirement benefit adjustment	0.0	0.0	0.0	0.0	0.0
Adjusted common equity	8,951.8	8,777.6	8,423.2	7,066.7	3,198.5
Plus admissible preferred and hybrids	0.0	0.0	0.0	0.0	0.0
Plus general reserves	0.0	0.0	0.0	0.0	0.0
Plus unrealized gains	N/A	0.0	0.0	0.0	0.0
Minus equity in unconsolidated subsidiaries	(525.3)	(416.2)	(112.9)	(78.1)	0.0
Minus capital of insurance subsidiaries	N/A	0.0	0.0	0.0	0.0
Minus adjustment for securitized assets	0.0	0.0	0.0	0.0	0.0
Minus other adjustments	N/A	0.0	0.0	0.0	0.0
Adjusted total equity	8,426.5	8,361.4	8,310.3	6,988.6	3,198.5
N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.					

Table 6: DUBAI ISLAMIC BANK PROFIT AND LOSS

--Year-ended Dec. 31 --					
Mil. AED	2009	2008	2007	2006	2005
Net interest income	2,338.7	2,244.5	1,485.6	1,057.1	662.0
Interest income	4,077.9	4,022.1	3,880.7	2,814.7	1,580.4
Interest expense	1,739.2	1,777.7	2,395.1	1,757.6	918.4
Operating noninterest income	1,059.7	1,248.2	2,202.7	1,761.7	1,115.7
Fees and commissions	652.3	752.2	704.6	869.8	385.4
Trading gains	96.7	250.9	531.9	563.5	104.0
Other market-sensitive income	117.1	238.3	350.5	83.6	176.1
Equity in earnings of unconsolidated subsidiaries	17.3	126.5	203.5	16.1	0.3
Other noninterest income	191.2	98.7	126.9	121.0	91.4
Operating revenues	3,398.4	3,492.7	3,688.3	2,818.8	1,777.6
Noninterest expenses	1,356.7	1,419.7	1,505.4	1,158.4	569.5
Personnel expenses	813.2	882.5	866.5	636.7	335.2
Other general and administrative expense	524.8	517.0	610.8	511.5	203.4
Net operating income before loss provisions	2,041.7	2,073.0	2,183.0	1,660.4	1,208.2
Credit loss provisions (net new)	817.9	520.8	301.5	76.5	141.8
Net operating income after loss provisions	1,223.8	1,552.2	1,881.5	1,584.0	1,066.4
Nonrecurring/special income	0.0	0.0	969.0	0.0	0.0
Nonrecurring/special expense	4.7	0.0	351.8	0.0	0.0
Amortization of intangibles	0.0	0.0	0.0	0.0	0.0
Impairment of intangibles	0.0	0.0	0.0	0.0	0.0
Pretax profit	1,219.1	1,552.2	2,498.7	1,584.0	1,066.4
Tax expense/credit	6.8	(2.1)	(14.2)	6.1	3.0
Net income (before minority interest)	1,212.3	1,554.3	2,512.8	1,577.8	1,063.4
Minority interest in consolidated subsidiaries	4.8	0.0	12.4	17.8	2.3
Net income before extraordinary items	1,207.5	1,554.3	2,500.4	1,560.1	1,061.1
Net income after extraordinary items	1,207.5	1,554.3	2,500.4	1,560.1	1,061.1

N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

Table 7: DUBAI ISLAMIC BANK CORE EARNINGS RECONCILIATION TABLE

--Year-ended Dec. 31 --					
Mil. AED	2009	2008	2007	2006	2005
Net income (before minority interest)	1,212.3	1,554.3	2,512.8	1,577.8	1,063.4
Minus nonrecurring/special income	0.0	0.0	(969.0)	0.0	0.0
Plus nonrecurring/special expense	4.7	0.0	351.8	0.0	0.0
Plus or minus tax impact of adjustments	(0.0)	0.0	N/A	0.0	0.0
Plus amortization/ impairment of goodwill/ intangibles	0.0	0.0	0.0	0.0	0.0
Minus preferred dividends	0.0	0.0	0.0	0.0	0.0
Plus or minus other earnings adjustments	0.0	0.0	0.0	0.0	0.0
Core earnings	1,217.0	1,554.3	N/A	1,577.8	1,063.4

N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

Table 8: DUBAI ISLAMIC BANK RISK-ADJUSTED CAPITAL DATA

(Mil. AED)	Exposure*	Standard & Poor's RWA	Average Standard & Poor's RW (%)
<b>Credit risk</b>			
Government and central banks	10,084	403	4
Institutions	5,880	2,366	40
Corporate	46,499	81,709	176
Retail	12,384	9,366	76
Of which mortgage	4,029	1,763	44
Securitization	0	0	0
Other assets	5,149	7,724	150
Total credit risk	79,995	101,567	127
<b>Market risk</b>			
Equity in the banking book¶	4,489	32,801	731
Total market risk	--	32,801	--
<b>Operational risk</b>			
Total operational risk	--	6,916	--
(Mil. AED)		Standard & Poor's RWA	% of Standard & Poor's RWA
<b>Diversification adjustments</b>			
RWA before diversification		141,284	100
Total adjustments to RWA		29,422	21
RWA after diversification		170,706	121
(Mil. AED)		Total adjusted capital	Standard & Poor's RAC ratio (%)
<b>Capital ratio</b>			
Capital ratio before adjustments		9,996	7.1
Capital ratio after adjustments§		9,996	5.9
*Exposure at default. ¶Exposure and Standard & Poor's risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions. §Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. AED--United Arab Emirates Dirham. Sources: Company data as of Sep. 30, 2009, Standard & Poor's.			

## The Five Pillars Of Islamic Finance

### The ban on interest

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

### The ban on uncertainty or speculation

Uncertainty in contractual terms and conditions is forbidden. However, risk taking is allowed when all the terms and conditions are clear and known to all parties.

### The ban on financing certain economic sectors

Financing of industries deemed unlawful by Sharia--such as weapons, pork, and gambling--is forbidden.

### The profit- and loss-sharing principle

Parties to a financial transaction must share in the risks and rewards attached to it.

### The asset-backing principle

Each financial transaction must refer to a tangible, identifiable underlying asset.

## Vocabulary Of Islamic Finance

### Bay salam

A sales contract where the price is paid in advance and the goods are delivered in the future, provided that the characteristics of the goods are fully defined and the date of delivery is fixed.

### Diminishing musharaka

A form of partnership in which one of the partners undertakes to buy the equity share of the other partner gradually until ownership is completely transferred to the buying partner.

### Gharar

An exchange transaction in which one or both parties remain ignorant of an essential element of the transaction.

### Halal

Lawful; permitted by Sharia.

### Haram

Unlawful; prohibited by Sharia.

### IFI

Islamic financial institution.

### Ijara

Lease financing. The purchase of the leased asset at the end of the rental period is optional.

### **Ijara muntahia bittamleek**

A form of lease contract that offers the lessee the option to own the asset at the end of the lease period, either by purchase of the asset through a token consideration or payment of the market value, or by means of a gift contract.

### **Ijara wa iqtina**

Lease purchasing, where the lessee is committed to buying the leased equipment at the end of or during the rental period.

### **Investment risk reserve**

The amount appropriated by an IFI from the income of PSIA holders, after allocating the mudarib's share of the profit or mudarib fee (mudarib refers to the IFI as a manager of the PSIA), in order to create a cushion against future investment losses for account holders.

### **Istisna**

A contract that refers to an agreement to sell to a customer a nonexistent asset, which is to be manufactured or built according to the buyer's specifications and is to be delivered on a specified date at a predetermined selling price.

### **Mudaraba**

A contract between a capital provider and a mudarib (skilled entrepreneur or managing partner) whereby the IFI provides capital to an enterprise or activity to be managed by the mudarib. Profits generated by that enterprise or activity are shared in accordance with the terms of the mudaraba agreement while losses are borne solely by the capital provider, unless the losses are due to the mudarib's misconduct, negligence, or breach of contractual terms.

### **Murabaha**

The financing of a sale at a determined markup (cost plus profit margin).

### **Musharaka**

A contract between an IFI and a customer to provide capital to an enterprise, or for ownership of real estate or a moveable asset, either on a temporary or permanent basis. Profits generated by the enterprise or real estate/asset are shared in accordance with the terms of the musharaka agreement, while losses are shared in proportion to each partner's share of capital.

### **Profit equalization reserve**

The amount appropriated by an IFI from mudaraba income before allocating the mudarib share (fee; mudarib refers to the IFI as a manager of the PSIA), in order to maintain a certain level of return on investment for PSIA holders.

### **PSIA (profit-sharing investment account)**

A financial instrument relatively similar to time deposits of conventional banks. According to the terms and conditions of PSIAs, depositors are entitled to receive a share of a bank's profits, but also obliged to bear potential losses pertaining to their investment in the bank. PSIAs can be restricted (whereby the depositor authorizes an IFI to invest his funds based on a mudaraba or wakala, with certain restrictions as to where, how, and for what purpose these funds are to be invested); or unrestricted (whereby the depositor authorizes the IFI to invest his funds based on mudaraba or wakala contracts without laying down any restrictions).

### **Qard hasan**

A loan granted for welfare purposes or to bridge short-term funding requirements; it could also take the form of a nonremunerated deposit account. The borrower is required to repay only the principal.

### **Retakaful**

A form of Islamic reinsurance that operates on the takaful model.

### **Riba**

Usury.

### **Sharia (or Shari'ah)**

Islamic law.

### **Stability rating**

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

### **Sukuk**

Sharia-compliant financial certificates similar to bonds.

### **Takaful**

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

### **Wadia**

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

### **Wakala**

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

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

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