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The Sukuk Market Continues To Soar And Diversify, Held Aloft By Huge Financing Needs

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The Sukuk Market Continues To Soar And Diversify, Held Aloft By Huge Financing Needs

The sukuk market more than doubled in 2007 to exceed \$60 billion--continuing its explosive growth since 2001 when it totaled less than \$500 million. In this roundup of developments in the sukuk market, Standard & Poor's Ratings Services expects growth of this Islamic financial instrument to remain on the same impressive trajectory and issues outstanding to top the symbolic \$100 billion mark in the next few years, fueled by huge investment and financing needs--notably in countries of the Gulf and Asia. That said, sukuk are becoming a global phenomenon, attracting more issuers from a larger pool of countries than ever before.

This type of financing is set to continue providing issuers with nonbank alternatives to longer-term funding. Sukuk growth nevertheless has been slowed in the past six months by unfavorable credit market conditions. Some sukuk were postponed when liquidity dried up and credit spreads widened. But once market conditions return to normal, we expect issuance to resume double-digit growth.

Most sukuk issued last year were "ijara" (lease financing) or "musharaka" (venture capital financing) varieties, but in the future we believe other types will become more common. To date, Standard & Poor's rates 22 sukuk, the bulk of which are ijara or musharaka and carry credit enhancements. (Please see our "Glossary Of Islamic Finance Terms," published Jan. 7, 2008, on RatingsDirect.)

The U.S. dollar continues to be the currency of choice for sukuk issuers, but has been declining in favor over the past five years. Corporates and entities involved in project finance are the main issuers, with banks coming in second. Corporates find that sukuk are an alternative to financing their business or their projects, and financial institutions are increasingly turning to sukuk to sustain strong lending growth with stable funding sources and to curb maturity mismatches.

Standard & Poor's role is to provide market participants with independent and objective opinions about the creditworthiness of issuers or issues--Sharia compliant or conventional. Our ratings represent opinions only about creditworthiness and do not address Sharia compliance. Over the past decade, we have refined our methodology to take into account the distinguishing features of Sharia-compliant issuers and issues.

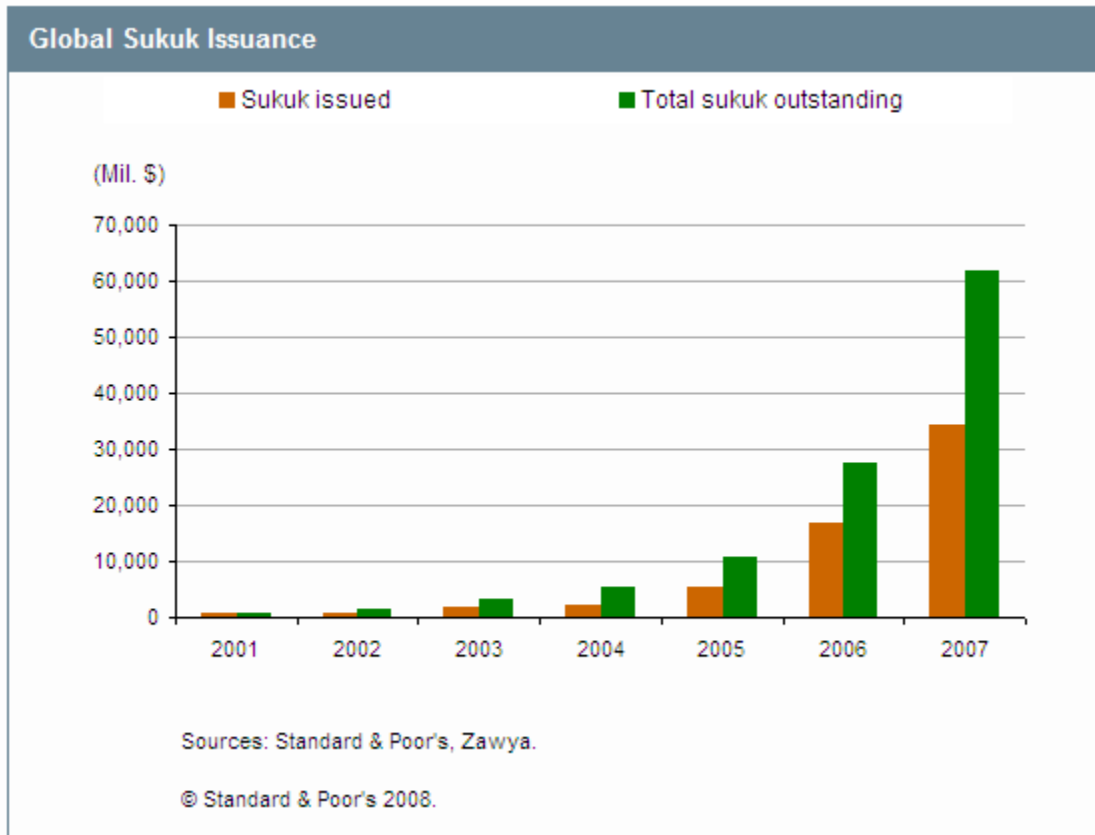
Sukuk Market Is Set To Exceed \$100 Billion In The Next Couple Of Years

Assuming credit market conditions return to normal, Standard & Poor's expects the sukuk market to top the symbolic mark of \$100 billion in the next couple of years (see chart 1). Sukuk issuance is taking off for several reasons:

- Regulators and governments in the Gulf and Muslim Asia support the development of Islamic finance, including the sukuk market.
- Massive infrastructure projects in the Gulf, estimated in excess of \$1.6 trillion, are going to require huge amounts of funding.
- Because of their rapid increase in residential real estate lending, banks in the Gulf are scrambling to balance their loans with stable funding.
- Issuers are looking to sukuk as an alternative way to tap cash-rich investors from the Middle East or Muslim

Asia, who are attracted by Sharia-compliant products.

Chart 1



We don't believe that growth of the sukuk market will be stunted by the recent debate among Sharia scholars about the Sharia compliance of sukuk issued so far. As we've said, our ratings on sukuk are opinions only about credit quality--not about whether they are Sharia-compliant. That said, we believe the current debate is likely to introduce more standardization and encourage innovation in this field--particularly the emergence of sukuk that are solely backed by assets and do not benefit from "credit enhancements" or third-party guarantees and associated features that add to a sukuk's creditworthiness.

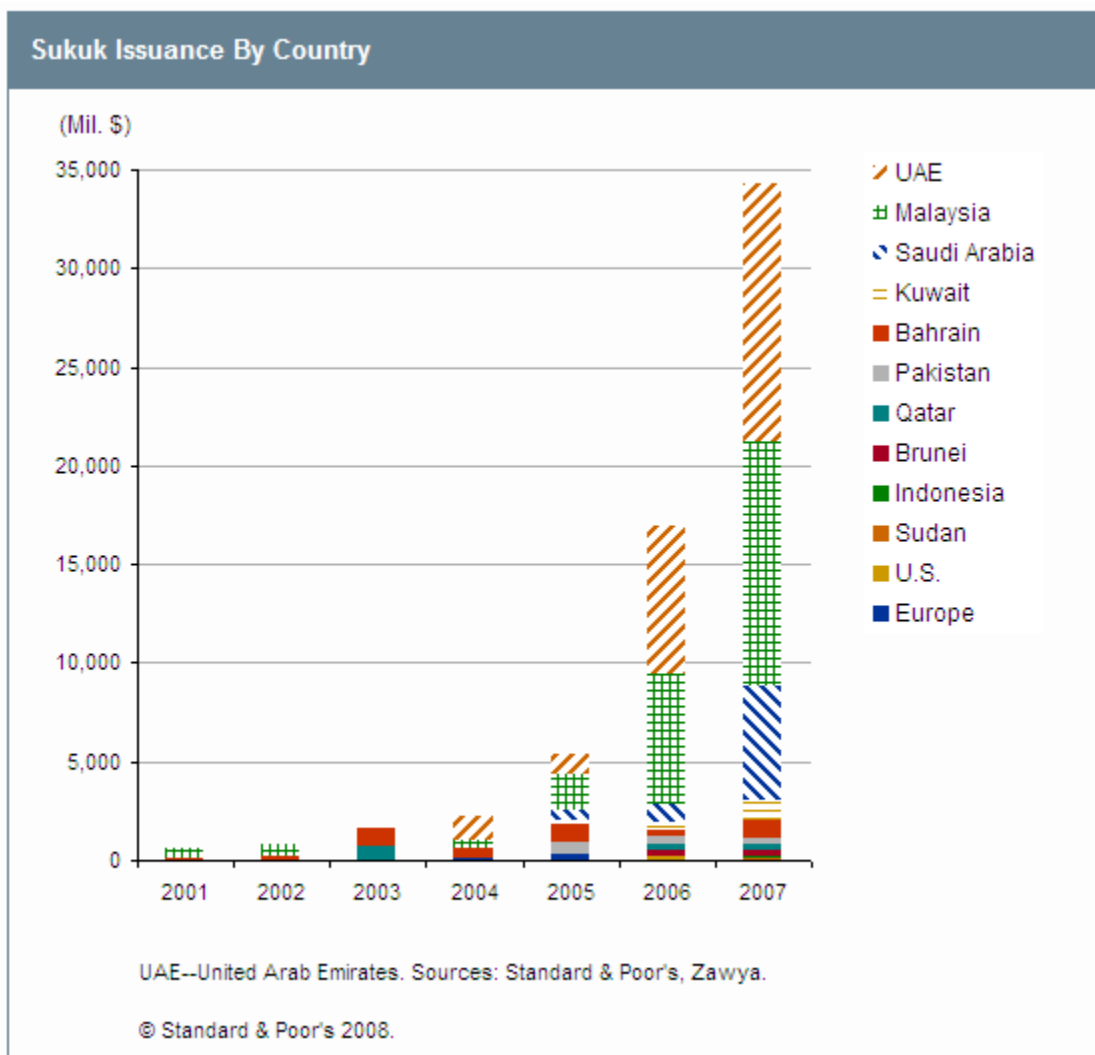
Standard & Poor's sees great potential for sukuk to help fund mortgage lending--through asset-backed sukuk. Residential real estate lending by banks has been booming in the countries of the Gulf Cooperation Council--comprising Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates--over the past couple of years. As a result, financial institutions in the Gulf are experiencing widening mismatches between the longer-term maturities on the loans they extend and the shorter-term financing that backs them. Consequently, they need greater access to longer-term funding. The environment therefore seems more fertile for the emergence of securitization--Islamic and conventional. There have already been some Islamic asset-backed transactions, such as the Caravan I Limited (not rated) issued in Saudi Arabia in 2004 and backed by a portfolio of auto ijara. As the region becomes more familiar with securitization techniques, the sukuk market is set to benefit from a wave of opportunities and innovation.

But there are some challenges that could hinder growth of securitization--whether it is Sharia compliant or not. In particular, the legal environment remains uncertain and largely untested by actual cases, and there are concerns about the legal transfer of title and foreclosure in case of default. These issues have to be resolved before asset-backed transactions, including those compliant with Sharia, take off.

Sukuk Issuance Is A Global Phenomenon

The sukuk market is attracting more issuers from a larger number of countries than ever before (see chart 2), in a trend that is set to continue. In 2001, only four sukuk were issued from Bahrain and Malaysia. In 2007, more than 100 sukuk were issued from 10 countries. In the future, we expect other non-Muslim countries to join the club, such as the U.K. and Japan. The U.K. government in November 2007 published a "consultation," seeking views from the public about its potential issue of a wholesale British sterling-denominated sukuk. Meanwhile, state-owned Japan Bank for International Cooperation announced its intention to issue \$150 million-\$200 million of sukuk by May 2008. In addition, issuers in countries such as Indonesia and Sudan have either expressed their interest in or already issued sukuk.

Chart 2

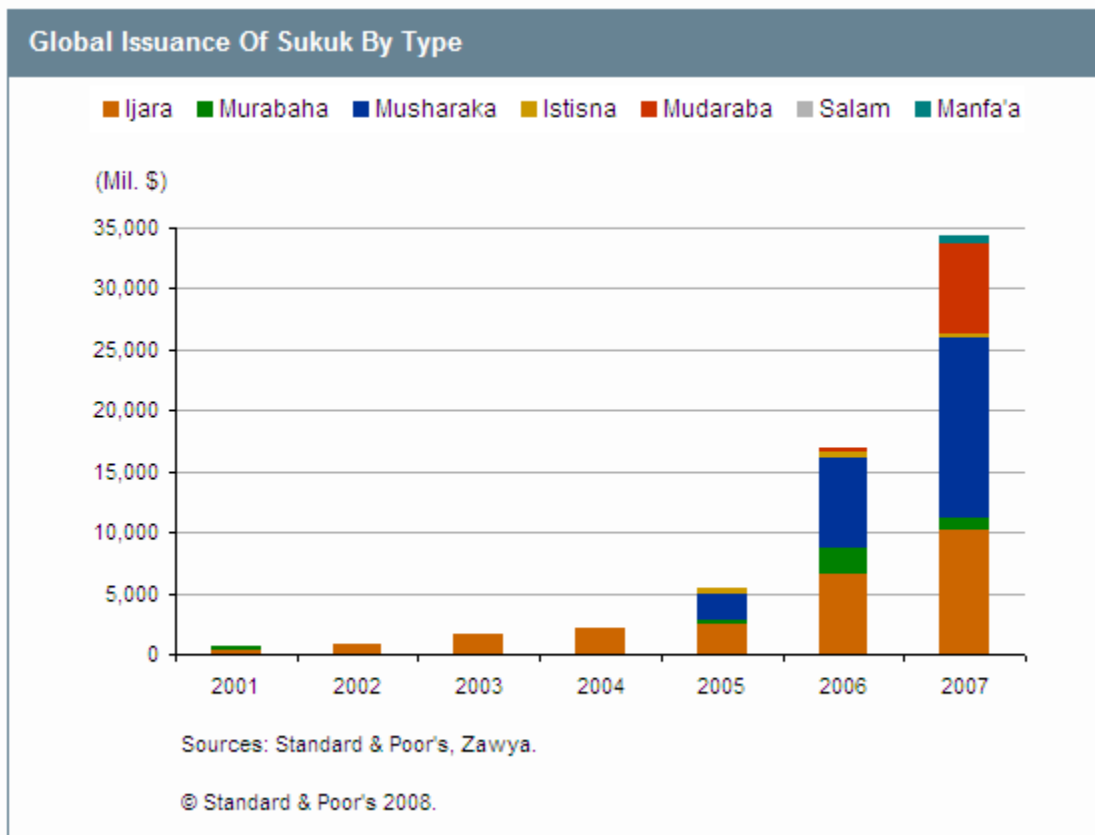


The United Arab Emirates (UAE) and Malaysia continue to be the two main locomotives of sukuk issuance. In 2007, more than \$25 billion of sukuk--or about three-quarters of all sukuk issued that year--originated from these two countries. We expect them to continue to be the giants in the market, thanks to their regulators' support of the development of Islamic finance and the UAE's status as the Middle Eastern gateway to global investors.

Ijara And Musharaka Are The Most Popular Types

In 2007, about three-quarters of the sukuk issued globally were ijara and musharaka structures. There are 14 ways to structure sukuk according to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). But so far, issuers are using only seven structures. These are ijara, musharaka, mudaraba, murabaha, istisna, salam (presale of future delivery of goods or commodities), and manfa'a (assets usufruct selling) (see chart 3).

Chart 3



We Classify Sukuk According To Their Credit Enhancement Features

To determine the creditworthiness of a sukuk, Standard & Poor's distinguishes among three types:

Sukuk with full credit enhancement mechanisms.

Under this structure, sukuk receive an irrevocable third-party guarantee, usually by a parent or original owner of the underlying assets. The guarantor must provide shortfall amounts in case the issuing vehicle, usually a

special-purpose entity or SPE, cannot make payment. The ratings on this type of sukuk are largely dependent on the creditworthiness of the guarantor or the entity providing the credit enhancement mechanisms, as well as the ranking of the guarantee--usually senior unsecured--among other financial obligations of the guarantor.

Sukuk with no credit enhancement mechanisms.

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

Sukuk with partial credit enhancement mechanisms.

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

Most sukuk that have been issued so far fall into the first category. The recent debate by Sharia scholars about the Sharia compliance of sukuk stands to encourage innovation in Islamic finance and act as a catalyst for the second and third types of sukuk. To date, Standard & Poor's rates 22 sukuk (see table 1), which all have full credit enhancement features and therefore fall into the first category.

Table 1

Sukuk Rated By Standard & Poor's				
Originator	Date of rating	Issue amount (mil. \$)	Rating*	
Central Bank of Bahrain	Various	1,094	A	
DIB Sukuk Co. Ltd.	15-Feb-07	750	A	
DP World Sukuk Ltd. (Obligor: DP World)	27-Jun-07	1,500	A+	
Dubai Sukuk Center Ltd. (Guarantor: DIFC Investment LLC)	25-May-07	1,250	A+	
East Cameron Gas Company	31-Jul-06	166	CCC+	
EIB Sukuk Co. Ltd. (Guarantor: Emirates Bank International)	15-May-07	1,000	A	
GFH Sukuk Ltd. (Obligor: Gulf Finance House)	26-Jun-07	1,000	BBB-	
Gold Sukuk dmcc (Guarantor: Dubai Multi Commodities Centre Authority)	11-Apr-05	200	A	
Golden Belt 1 B.S.C.	18-Apr-07	650	BBB+	
Islamic Development Bank	20-May-05	1,000	AAA	
Ithmaar Sukuk Company Ltd. (Guarantor: Shamil Bank of Bahrain)	20-Jun-07	¶	BBB-	
JAFZ Sukuk Ltd.	8-Nov-07	AED7.5 billion	A+	
Loehmann's Capital Corp. (Guarantor: Loehmann's Holdings Inc.)	22-Sep-04	110	CCC+	
Malaysia Global Sukuk Inc. (Obligor: Federation of Malaysia)	10-Jun-02	600	A-	
MBB Sukuk Inc.	11-Apr-07	300	BBB+	
Pakistan International Sukuk Co.	23-Dec-04	600	B+	
Qatar Global Sukuk QSC	10-Sep-03	700	AA-	
Sarawak Corporate Sukuk Inc.	30-Nov-04	350	A-	
Sharjah Islamic Bank	12-Sep-06	255	BBB	
Solidarity Trust Services Ltd. (Guarantor: Islamic Development Bank)	11-Aug-03	400	AAA	
Stichting Sachsen-Anhalt Trust	9-Jul-04	130	AA-	

Table 1

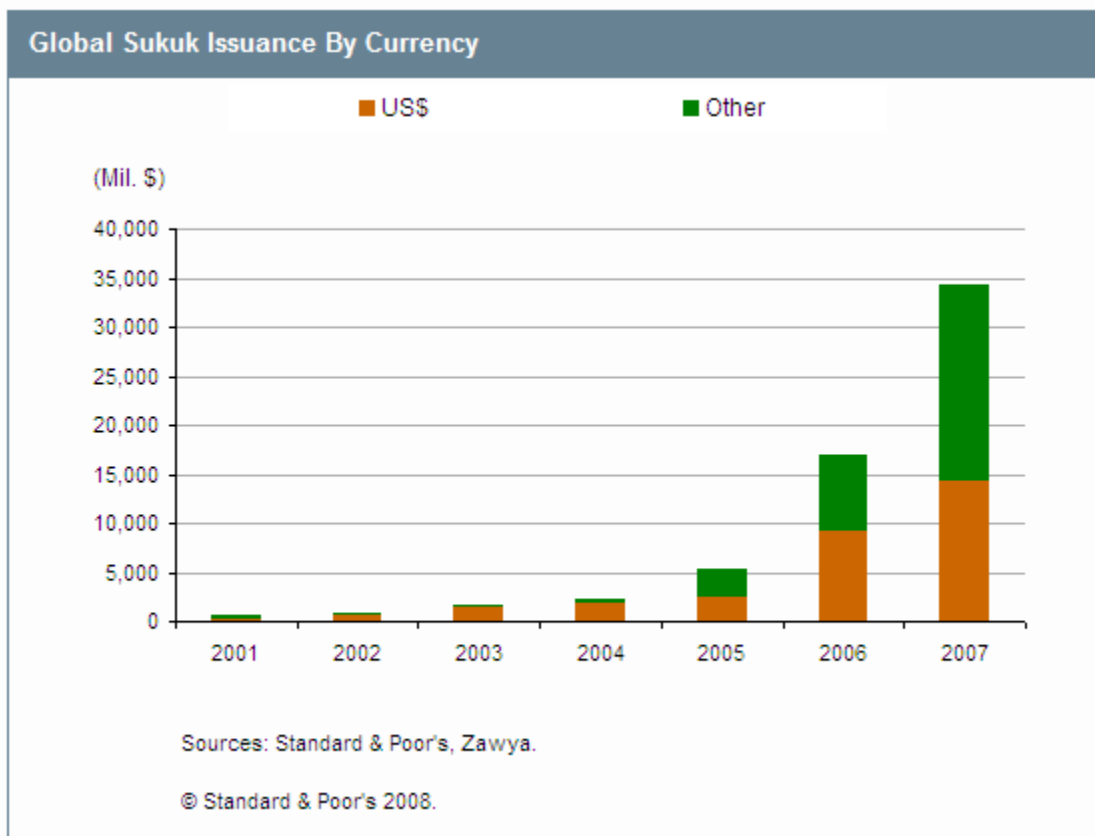
Sukuk Rated By Standard & Poor's(cont.)			
Tabreed 06 Financing Corp.	15-Jun-06	200	BBB-

*Long-term foreign currency rating as of March 11, 2008. †To be determined. AED--United Arab Emirates dirham.

Dollar-Denominated Sukuk Dominate, But Local Currency Issues Are Gaining Favor

The U.S. dollar was the currency of choice for sukuk issuers from 2002 to 2007, but has been declining in favor of local currency-denominated sukuk (see chart 4). The percentage of U.S. dollar-denominated sukuk declined to 41.8% in 2007 from 85% in 2002. The other major currencies of issuance in 2007 were the Malaysian ringgit, the UAE dirham, and the Saudi Arabian riyal.

Chart 4

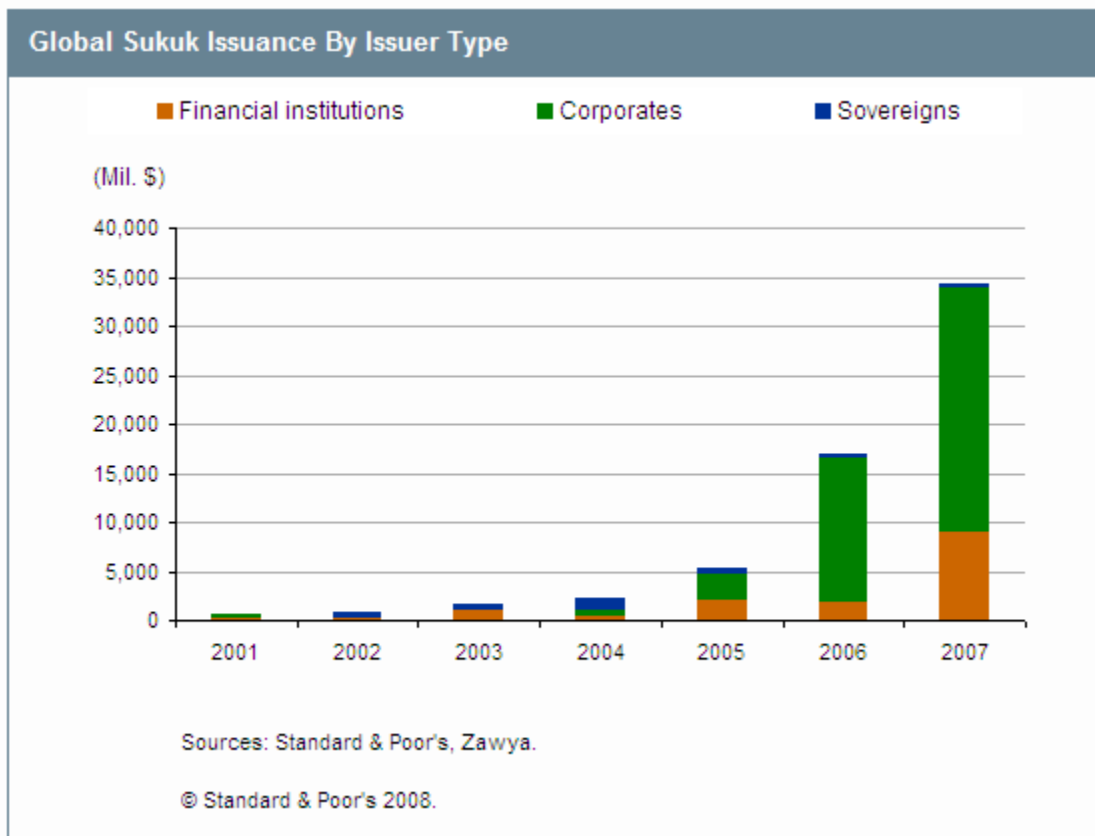


The decline in U.S. dollar issuance mainly reflects the currency's weakness in the past 18 months compared with other major currencies, as well as the huge amount of liquidity in the Gulf that sukuk issuers want to tap. In addition, sukuk issued out of Malaysia are typically denominated in Malaysian ringgit. We expect a significant share of sukuk issuers to continue to depend on the U.S. dollar, mainly because they're financing projects--notably infrastructure projects--in the Gulf where the costs in most cases are denominated in foreign currencies, especially for raw materials. However, we also expect more local currency issuance whenever the pool of the underlying assets is denominated in local currency--especially when genuine asset-backed sukuk take off.

Corporates And Financial Institutions, The Main Issuers, Are Powering Growth Of The Market

Growth of the sukuk market is being fueled mainly by corporates--including those involved in project finance--and financial institutions (see chart 5). Although corporates find that sukuk are an alternative for financing their business or their projects, banks are turning to these financial instruments to sustain growth with stable funding sources and curb maturity mismatches. Financial institutions and governments or government-related bodies were the first to issue sukuk, and accounted for 58% and 42% of total issuance in 2003. The corporate sector took the lead in 2005 and since then has been the biggest contributor to the growth of sukuk market. In 2007, issues by financial institutions grew strongly, accounting for 26.2% of total sukuk, and they will likely continue to be big issuers. Furthermore, Standard & Poor's believes that especially asset-backed sukuk issued by financial institutions in the Middle East have great potential, owing to their increasing need to tap the international markets to feed their impressive growth, notably in the residential real estate segment.

Chart 5



Standard & Poor's Role In The Market For Sukuk

Our role is to provide market participants with independent and objective opinions about the creditworthiness of issuers or issues--including those involving sukuk. We do not comment on the degree of compliance with Sharia of a particular issue or issuer. Our long-standing expertise in Islamic finance will continue to serve the development of

the sukuk market, which is set to remain strong. Our ratings do not constitute a recommendation to sell, buy, or hold a particular security--whether it is Sharia-compliant or not. Instead, our ratings help investors to make informed decisions and issuers to benchmark their creditworthiness against peers'. Over the past 10 years, Standard & Poor's has continued to refine its methodology to take into account the distinguishing features of Sharia-compliant issues and issuers.

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