

Credit Encyclopedia Series

Guide to Islamic Finance: Fitch Ratings' Perspective

FitchRatings

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Introduction to Islamic Finance

What is Islamic Finance?

Islamic finance is a form of financing in which all transactions must comply with sharia (Islamic rulings), which is a broad term used for a system of beliefs revealed in the Holy Qur'an and the Sunna. Since their development over 1,400 years ago, the key principles of Islamic finance have broadly remained unchanged.

The principles of Islamic finance include the prohibition of the collection and payment of Riba (ربا), which refers to the charging of interest on money lent, as well as any unjustified monetary increase or addition, premium or surplus. Hence, under Islamic principles, invested funds can only create returns on the basis of sharing risks and rewards in a business venture. The key concept to grasp when it comes to understanding the idea of the prohibition of Riba is that it is not acceptable for income to be guaranteed, regardless of the purpose for which the money was originally borrowed.

Gharar (غرر), which refers to uncertainty, ambiguity, peril, risk or hazard, is also prohibited. In particular, there should be no uncertainty or ambiguity in the fundamental terms of a contract, such as price, tenor and delivery, as well as each party's obligations and rights, as this could lead to potential speculation. The principle of Gharar is most relevant when discussing the terms of exchange, such as deliverability, quantity and quality of the underlying assets.

It also relates to any gain obtained by chance or from transactions related to uncertain events, which should be avoided. This does not mean the avoidance of any type of risk, as the incurrence of commercial risk is acceptable under sharia law, provided the risk is jointly shared among partners.

Maisir (ميسر), or gambling, is also prohibited in Islam. Hence, some contracts pertaining to futures and options are considered unacceptable, as these could be used for speculative purposes. Additionally, income from non-sharia-compliant activities, such as alcohol production, pork breeding and pornography, must also be avoided. Hence, Islamic finance can be considered a culturally distinct type of ethical finance.

Islamic Financial Institutions operate using sharia-compliant contracts like Murabaha (installment sale), Ijara (leasing), Wakala (agency contract) and Mudaraba (profit-sharing contract), among others. While scholars agree on the main principles and modalities of Islamic finance, there is room for differences in interpretation between the various schools of Islamic religious scholarship and across jurisdictions.

Why a Centuries-Old Form of Financing is Hot Today

Breakdown of the Global Islamic Financial Services Industry by Segment and Region (USD bn, 2019*)

Region	Banking Assets	Sukuk Outstanding	Islamic Funds' Assets	Takaful Contributions	Total	Share
GCC	854.0	204.5	36.4	11.70	1,106.6	45.4%
South-East Asia	240.5	303.3	26.7	3.02	573.5	23.5%
Middle East and South Asia	584.3	19.1	16.5	11.36	631.3	25.9%
Africa	33.9	1.8	1.6	0.55	37.9	1.6%
Others	53.1	14.7	21.1	0.44	89.3	3.7%
Total	1,765.8	543.4	102.3	27.07	2,438.6	100%
Share	72.4%	22.3%	4.2%	1.1%	100%	

* Data for Sukuk outstanding and Islamic funds are for full-year 2019; figures for Islamic banking are as of 3Q19; data for takaful are as of end-2018.

Notes: (a) Data are mostly taken from primary sources (regulatory authorities' statistical databases, annual reports and financial stability reports, official press releases and speeches, etc., and the IFSB's PSIFI database).

(b) Where primary data are unavailable, third-party data providers have been used, including Bloomberg.

(c) Takaful contributions are used as a basis to reflect the growth in the takaful segment.

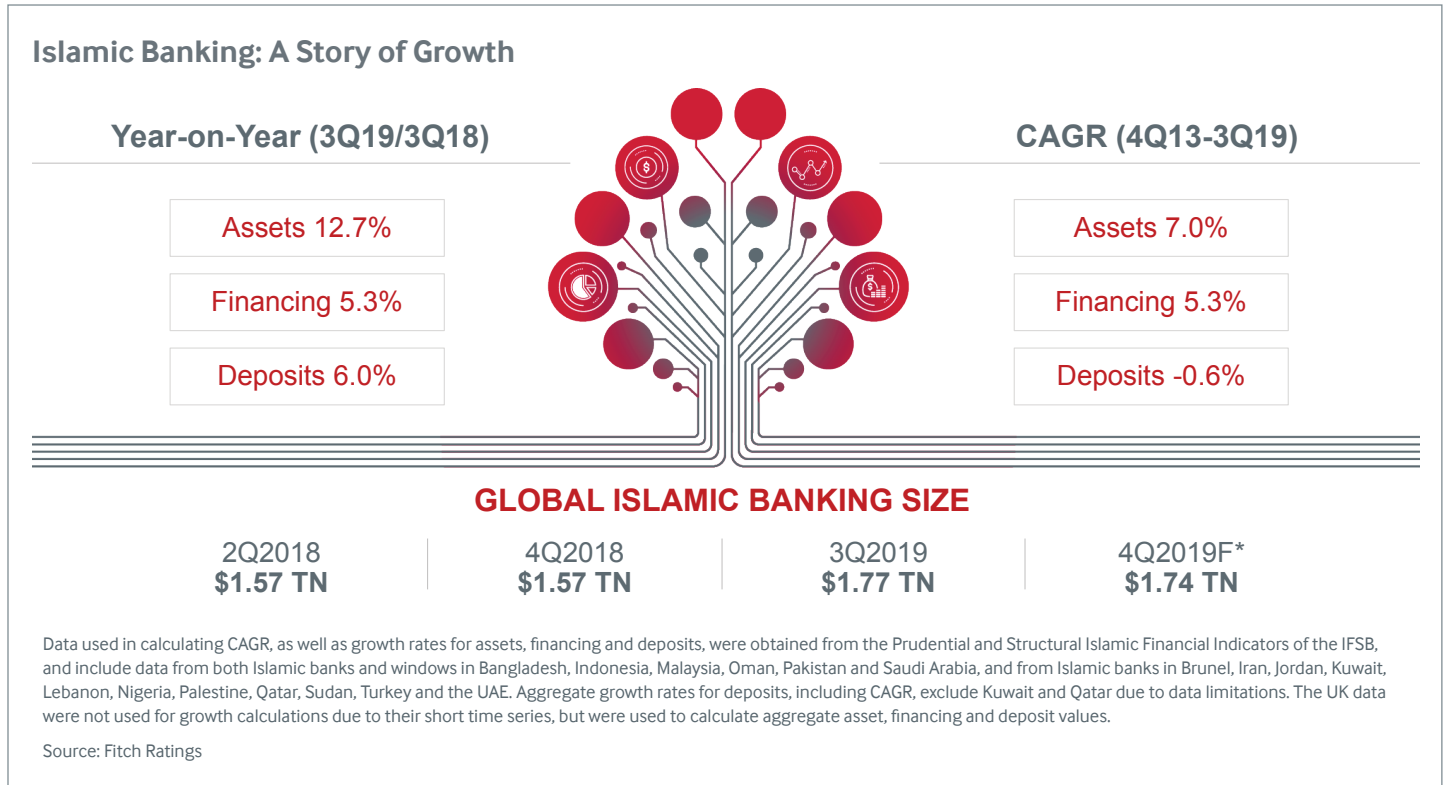
(d) The breakdown of Islamic fund assets is by domicile of the fund, while that for sukuk outstanding is by domicile of the obligor.

(e) The regional classification is different from that used in the previous IFSI stability reports. Other than the GCC and South-East Asian region, a new classification – Middle East and South Asia (MESA) – is used to capture other jurisdictions in Asia. The African region now includes both North Africa and Sub-Saharan Africa. Jurisdictions not belonging to any of the four regions are classified as 'Others', specifically countries located in Europe, North America, South America, and Central Asia.

Source: IFSB Secretariat Workings

Islamic finance is not a new phenomenon, dating back to as far as the Middle Ages. However, since its modern inception in the 1970s, the Islamic financial services industry (IFSI) has grown significantly, and is worth USD2.4 trillion as of 2019, according to the Islamic Financial Services Board (IFSB).

At present, there are more than 500 Islamic banks operating in over 70 countries, comprising most of the Muslim world and many Western and Asian economies. Furthermore, in 13 jurisdictions Islamic banking is considered to be systemically important. The top ten countries where Islamic finance is prevalent are Saudi Arabia, Malaysia, United Arab Emirates (UAE), Kuwait, Bahrain, Qatar, Oman, Indonesia, Turkey and Pakistan. In many of these jurisdictions, Islamic banking is expected to continue to grow rapidly and become a potential substitute for conventional financing.



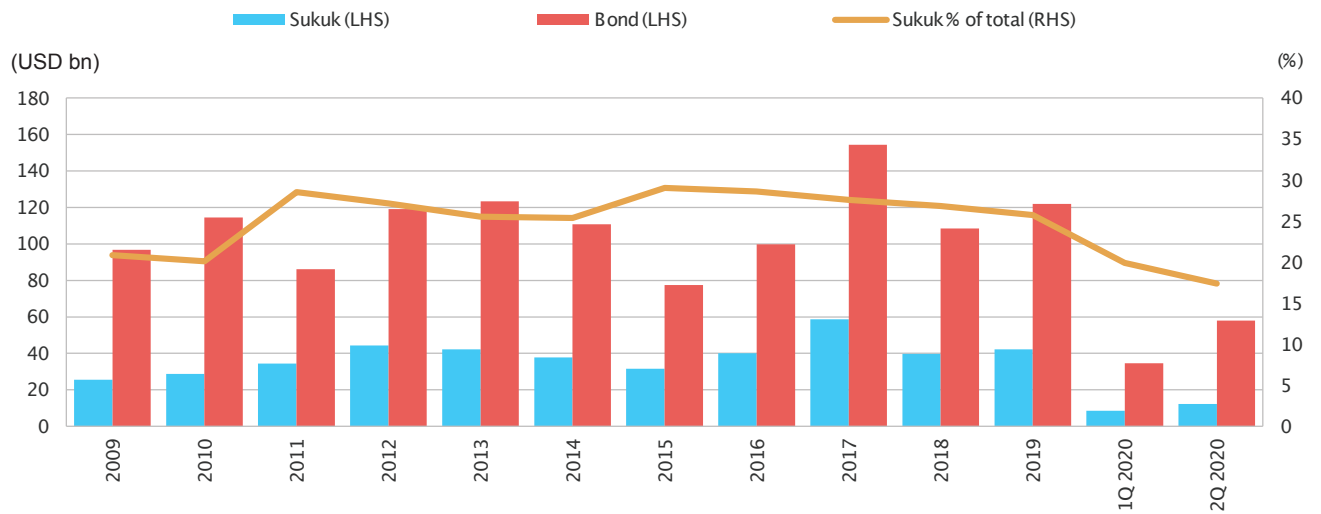
The Islamic finance industry's remarkable growth in its early years is attributed to the growing financial resources and wealth of oil-producing countries in the Middle East and Asia, where Islam is the main religion. Another factor is the growing financial sophistication of Islamic finance clients. Similar to the Western world, where ethical finance is increasing in importance, the emerging Islamic banking sector is gaining acceptance throughout the Middle East, Asia and Africa, with funds managed by Islamic institutions continuing to grow.

Islamic financial products and services have also found ground in non-Muslim countries like the United Kingdom, Ireland, Luxembourg, Hong Kong and South Africa. The industry's evolution demonstrates that sharia-compliant financial products and services are recognized and accepted as part of the international finance system.

Driven by these developments, financial institutions, investors and entrepreneurs are targeting the large Muslim population around the world, estimated at 1.8 billion individuals, with a range of increasingly sophisticated financial products and services, which are both ethically and socially sound, as well as sharia-compliant. Various international banks also provide Islamic financial services in these jurisdictions, for example HSBC Amanah, Standard Chartered Saadiq, Citi Islamic Investment Bank and BNP Paribas Najmah.

Sukuk, or Islamic bonds, are also increasingly prominent funding tools for sovereigns, financial institutions and corporates in many of these jurisdictions. Since the inception of the global sukuk market, more than USD1.5 trillion has been raised through sukuk issuance as of 10 August 2020, according to Bloomberg.

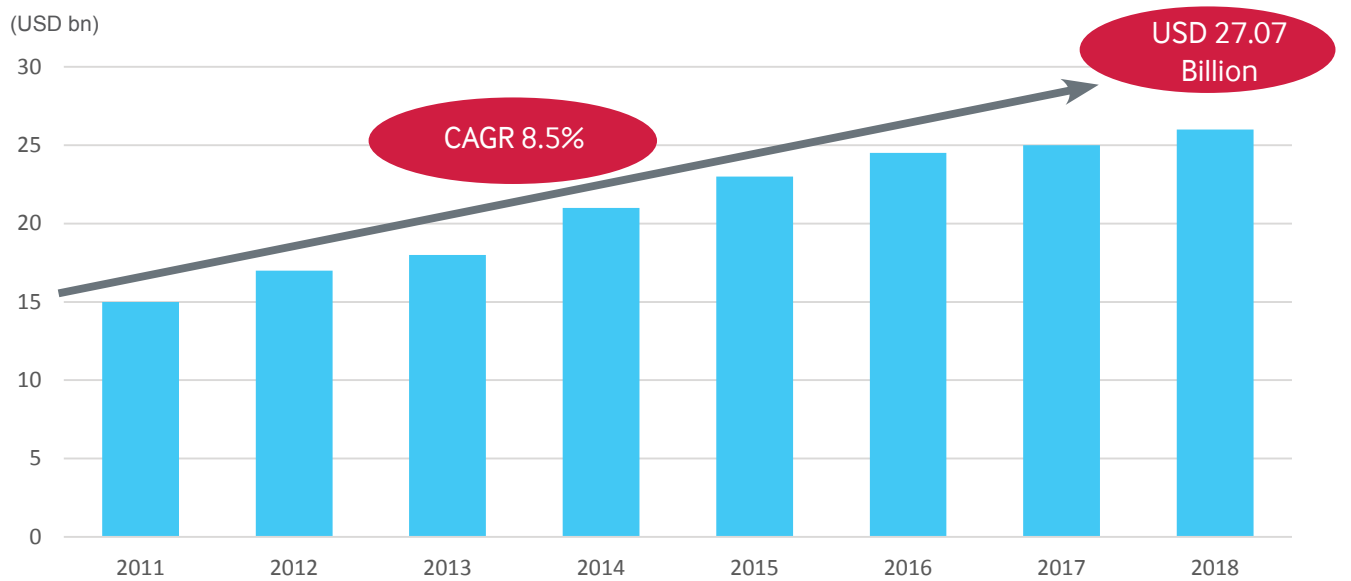
Sukuk & Conventional Bond Issuance in Key Islamic Finance Jurisdictions



Source: Fitch Ratings, Dealogic

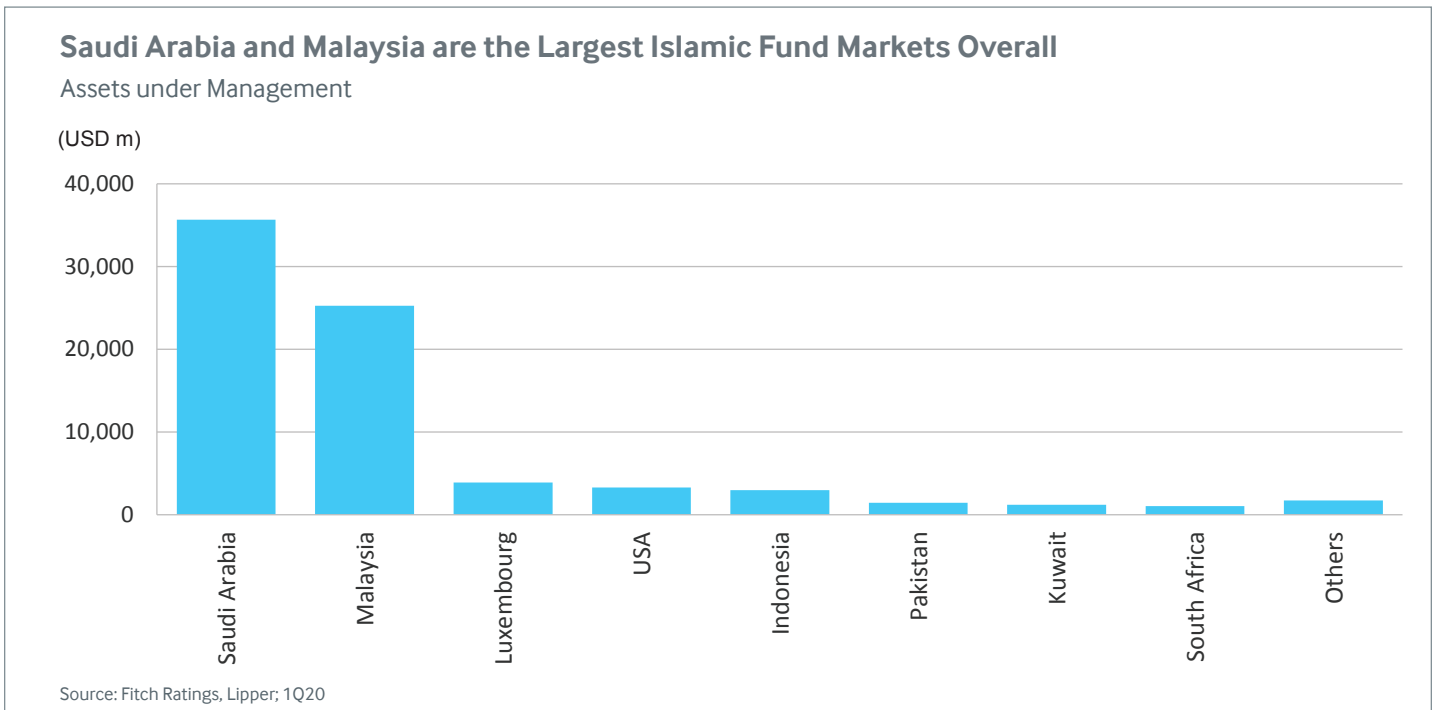
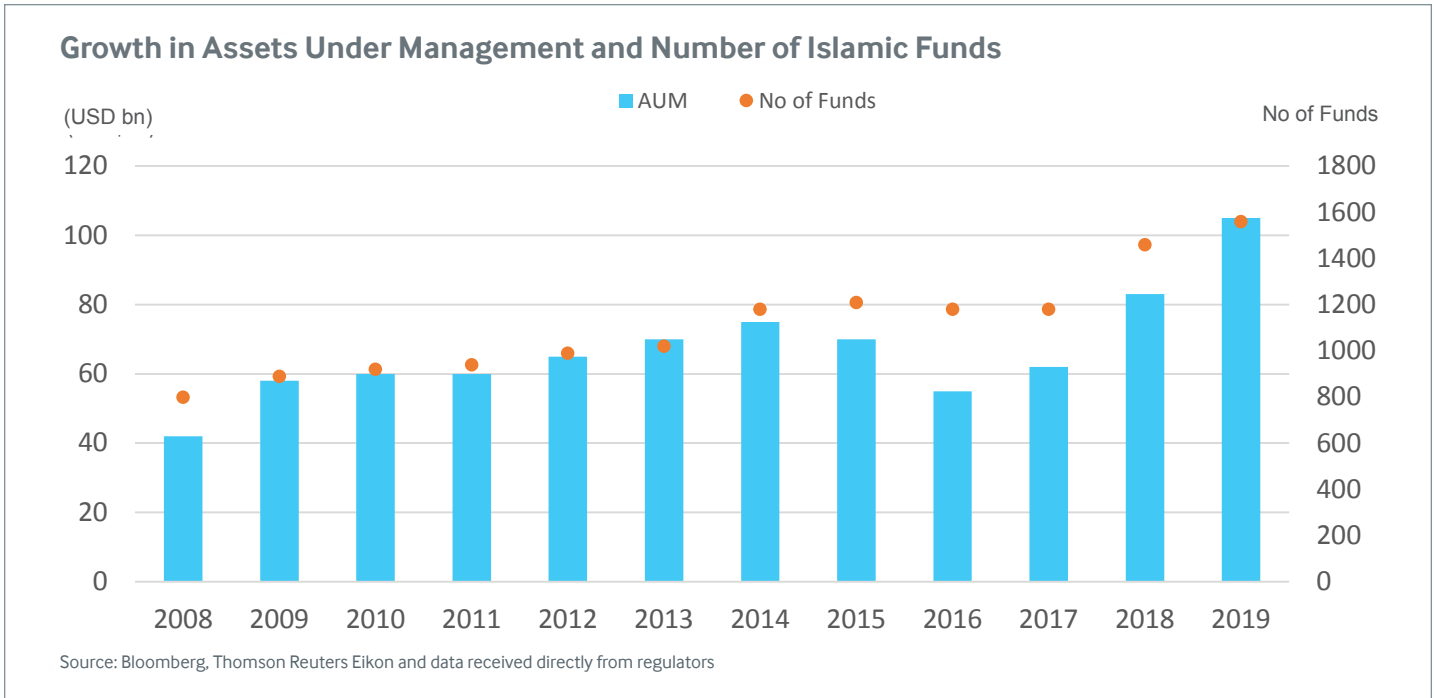
Takaful, or Islamic insurance, is now present in at least 33 countries globally, with more than 350 institutions providing these services, including retakaful and takaful windows. Most of these jurisdictions have developed specific takaful sector regulations.

Trend of Global Takaful Contributions (2011-18)



Source: IFSB Secretariat Workings

Furthermore, the volume of Islamic funds is also rising. In the 34 jurisdictions where Islamic funds are domiciled, the value of active AUM increased from USD 67.1 billion in 2018 to USD 102.3 billion in 2019, while the number of funds increased from 1,489 to 1,545. Saudi Arabia and Malaysia are the pre-eminent Islamic fund domiciles.



According to ICD-Refinitiv Islamic Finance Development Report 2019, the Islamic finance industry is expected to reach USD3.5 trillion by 2024. In the future, the strongest economic growth is expected in countries with large, underbanked Muslim populations. Analysts predict that by 2050, Muslims will make up a third of the world's population, with the largest untapped growth markets for Islamic finance located in Africa and Asia.

Sukuk in Focus

What are Sukuk?

“Sukuk” is the plural of the Arabic term “sakk” (صك) which means certificate or deed. Sukuk have been developed as the Islamic finance industry’s alternative to conventional bonds and are commonly referred to as Islamic bonds. They are typically structured around contractual arrangements formulated according to sharia (Islamic rulings).

While the majority of the sukuk that have been issued to date create an economic effect similar to conventional bonds, they are in their legal form very different. Sukuk represent undivided shares in the ownership of tangible assets, including the assets of a particular project or investment activity, and their “usufruct” (i.e., the right to their use).

Islamic capital-market transactions in practice tend to be asset-based. The underlying assets in a sukuk do not necessarily constitute collateral and the transactions may therefore be effectively unsecured. Even when the assets constitute collateral, the legal environment may well prevent significant and timely recoveries. Furthermore, in an originator-backed sukuk, the sale of the underlying assets is not usually a true sale, instead, rights can be assigned without completing the necessary asset registration formalities.

While most sukuk instruments resemble debt obligations with fixed returns (e.g., ijara or murabaha sukuk), some can also resemble equity-like investments and contain a variable return component (e.g., through mudarabah or musharakah sukuk). Hybrid sukuk, which could have both equity and debt-like components (e.g. mudaraba-murabaha sukuk), are also on the rise.

Development of Sukuk as Modern Financial Instruments

The sukuk market is now a significant source of funding for many sovereigns, banks and corporates in the Middle East and Southeast Asia, regions that are home to fast-growing Muslim populations. Active sukuk-issuing jurisdictions include Malaysia, Saudi Arabia, UAE, Kuwait, Indonesia, Bahrain, Qatar, Pakistan, Turkey and Oman.

The first sukuk in modern times was issued in 1990 by Shell MDS Sdn Bhd. Another 11 years passed before the first international U.S. dollar sukuk was issued — the Malaysian plantation company Kumpulan Guthrie Bhd’s USD150 million sukuk in 2001. The Bahrain Monetary Authority (now the Central Bank of Bahrain) was the first Government-Related Entity (GRE) to issue sukuk in 2001. This was followed by several sovereign sukuk, including those by the governments of Malaysia, Qatar, Pakistan and Dubai, which garnered international attention for sukuk and set the stage for international growth.

Malaysia has been active in this space, with sukuk representing more than 60% of the country’s local debt market in 2019. GCC members were not active issuers of either sukuk or bonds until 2016. Following the collapse of oil prices from 2014 to 2016, GCC members turned to sukuk and conventional bonds to fill government funding gaps.

In 2017, Saudi Arabia raised USD9 billion by issuing its first US dollar denominated sovereign sukuk, which is also the world’s largest sukuk issuance to date. The country continues to be a regular issuer of sovereign sukuk. Saudi Arabia’s Ministry of Finance also established an unlimited Riyal-denominated sukuk program in 2017, and under the program, sukuk have regularly been issued, which helped expand the local sukuk market. For example, in its June 2020 sukuk auction, Saudi Arabia raised SAR8.495 billion (USD2.27 billion). It is interesting to note that during 2019, Saudi Arabia financed over 50% of its fiscal deficit through sukuk issuances.

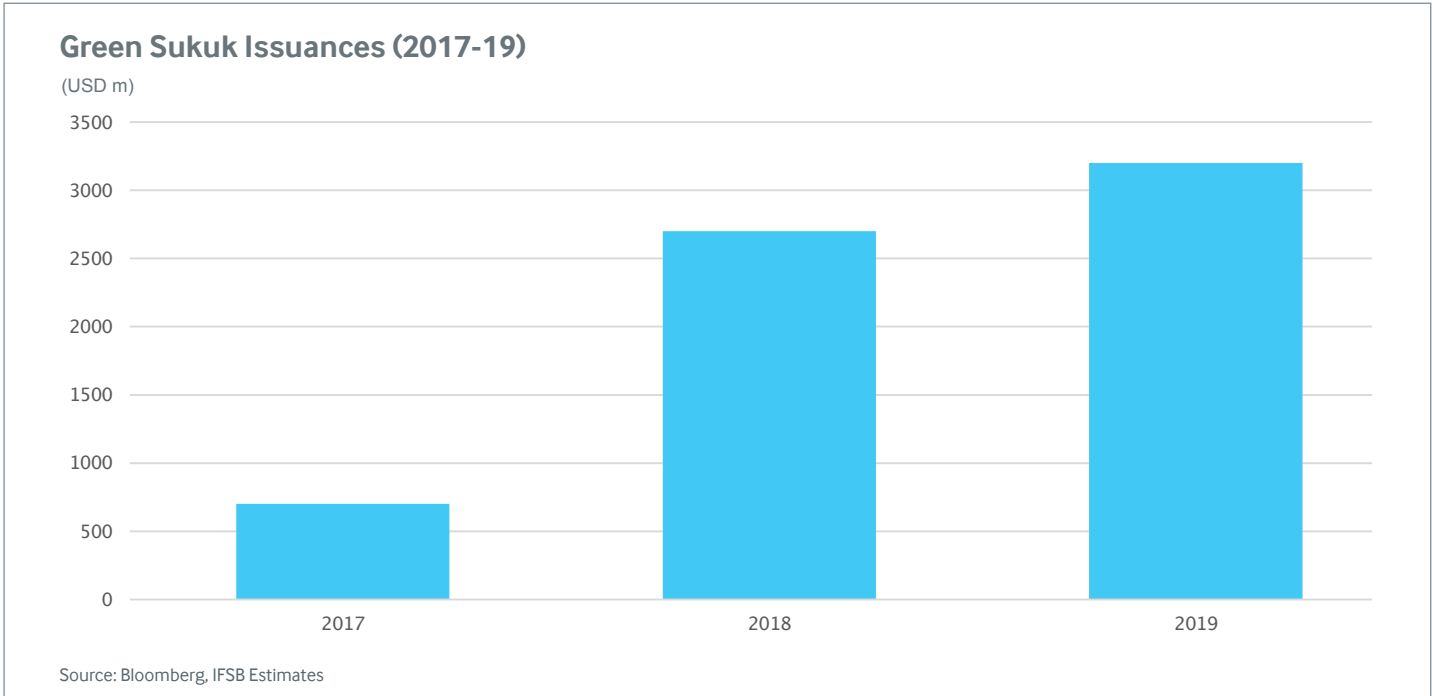
The governments of Bahrain, Qatar and Oman, and supranational entities like the Islamic Development Bank (IsDB) and the International Islamic Financial Market (IILM), have also been regular sukuk issuers. Multiple corporates from the UAE and Saudi Arabia have also issued international sukuk. Financial institutions (FI) are also active sukuk issuers since the industry’s modern inception. While sukuk are issued mostly for liquidity management purposes, they are now increasingly issued to meet Basel capital adequacy requirements, by issuing Tier 1 (perpetual) and Tier 2 (sukuk) instruments.

The increasing breadth and depth of the global sukuk market is also evidenced by its ability to provide longer-term financing. While most sukuk have a maturity of three to five years, the market has shown a willingness to invest in sukuk with longer maturities. In 2013, Saudi Electricity Company (SEC) issued the first international 30-year sukuk, which was more than five times oversubscribed. In 2019, Saudi Arabia issued its debut 30-year riyal-denominated sukuk, representing its longest-term domestic debt sale and helping to extend the domestic sukuk yield curve. In 2020, the government of Indonesia also issued a sukuk with a 30-year maturity and the issue was subscribed multiple times.

In addition, the market has also witnessed innovative issuances like the world’s first Formosa Sukuk, which was issued by Qatar Islamic Bank in January 2020 and is listed on the Taipei Stock Exchange.

1 Latham & Watkins | “The Sukuk Handbook: A Guide To Structuring Sukuk”

Emergence of Green Sukuk

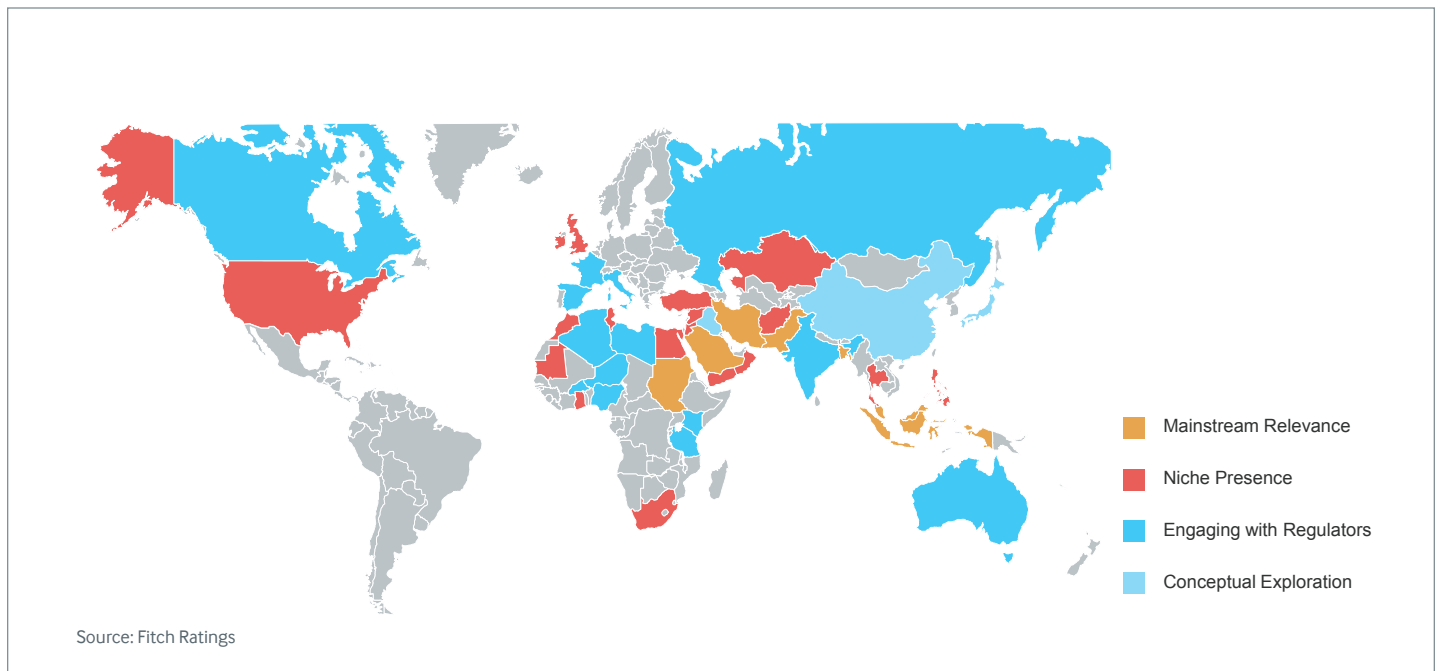


Green sukuk is also emerging as a notable segment of the global sukuk market. In 2018, Indonesia issued the world's first sovereign green sukuk and raised USD1.25 billion from a broad range of investors, including green, conventional and Islamic green investors. Indonesia returned to the market in 2019 and 2020 with new green sukuk issuances. In 2018, HSBC Amanah, the Malaysian Islamic banking arm of HSBC Holdings, issued the world's first United Nations (UN) Sustainable Development Goals (SDG) sukuk, raising 500 million ringgits (USD120.63 million).

In the GCC, Dubai-based real estate developer Majid Al Futtaim (MAF) issued the region's first green sukuk in 2019. In the same year, the Islamic Development Bank (IsDB) issued its maiden green sukuk with a sale of EUR1 billion. IsDB also launched its first sustainable sukuk in 2020, raising USD1.5 billion to tackle the aftermath of the COVID-19 pandemic in its member countries.

Green and Islamic investors aim to use their money in manners that comply with certain values and beliefs. Environmentally sustainable infrastructure projects, such as the construction of renewable or clean energy projects, that are funded through green sukuk could appeal to both sukuk investors and conventional environment-focused investors, as sukuk by design are structured based on a specific pool of assets. Financing sustainable infrastructure through green sukuk can also help governments meet sustainable development goals in their national and international agenda.

Increasing Interest from Non-Islamic Jurisdictions



Sukuk is increasingly gaining traction in many non-Islamic jurisdictions. This is because sukuk offerings allow issuers to tap into both the growing Islamic investor community, who wouldn't otherwise invest in conventional bond offerings, as well as the Western institutional investor community.

In June 2014, the UK became the first country outside the Islamic world to issue sovereign sukuk. This sukuk issuance attracted orders of more than £2 billion (USD3.05 billion) from global investors based in the UK, the Middle East and Asia. It was the UK government's desire to secure London as a global hub of Islamic finance which largely drove this issuance.

The government of Hong Kong soon followed suit with an inaugural sukuk issuance of USD1 billion in September 2014, as did Luxembourg, where a successful inaugural €2 billion (USD2.54 billion) sukuk was issued in October 2014, making Luxembourg the first ever European Monetary Union sovereign to issue sukuk. Furthermore, key listing venues for international sukuk include the London Stock Exchange (LSE), Irish Stock Exchange, Luxembourg Stock Exchange and Singapore Stock Exchange.

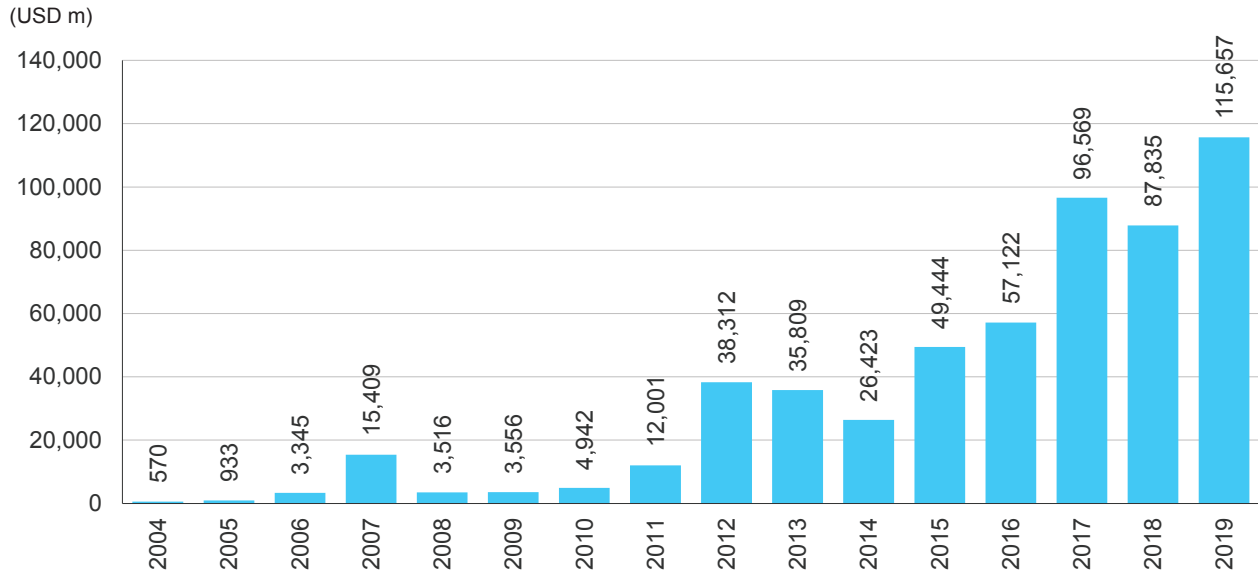
Sukuk issuances have also been gaining momentum in Africa, as African nations have turned to sukuk issuances as a means of sustaining fast economic growth through significant infrastructure development. In 2014, South Africa issued its inaugural sukuk worth USD500 million, which was the first dollar-denominated sukuk in Africa. In 2015, Côte D'Ivoire issued a 5-year CFA150 billion (USD269 million) sukuk and Togo issued a 10-year debut sukuk worth CFA150 billion (USD269 million) in 2016. Nigeria, Senegal and Morocco have also issued sukuk.

International corporations have tapped the sukuk market as well. GE Capital, the finance arm of General Electric, sold USD500 million of sukuk in 2009, becoming the first major U.S. corporation to do so. Sukuk have also been issued by institutions like Goldman Sachs, MUFG Bank, HSBC, International Finance Corporation (an affiliate of the World Bank), Virgin Mobile, Saudi Aramco and Emirates Airlines.

As the sukuk market has grown, it has generated increasing interest from European and U.S. institutional investors. Sukuk is increasingly viewed by them as a way to diversify their portfolios and achieve higher returns through investments in the emerging markets of Southeast Asia, the Middle East and North Africa. For example, 49% of DP World's 2020 issue of subordinated perpetual sukuk was sold directly to investors based in the UK and Europe. The issuance demonstrated that Western investors are becoming an important investor base for sukuk.

The Sukuk Market At Present

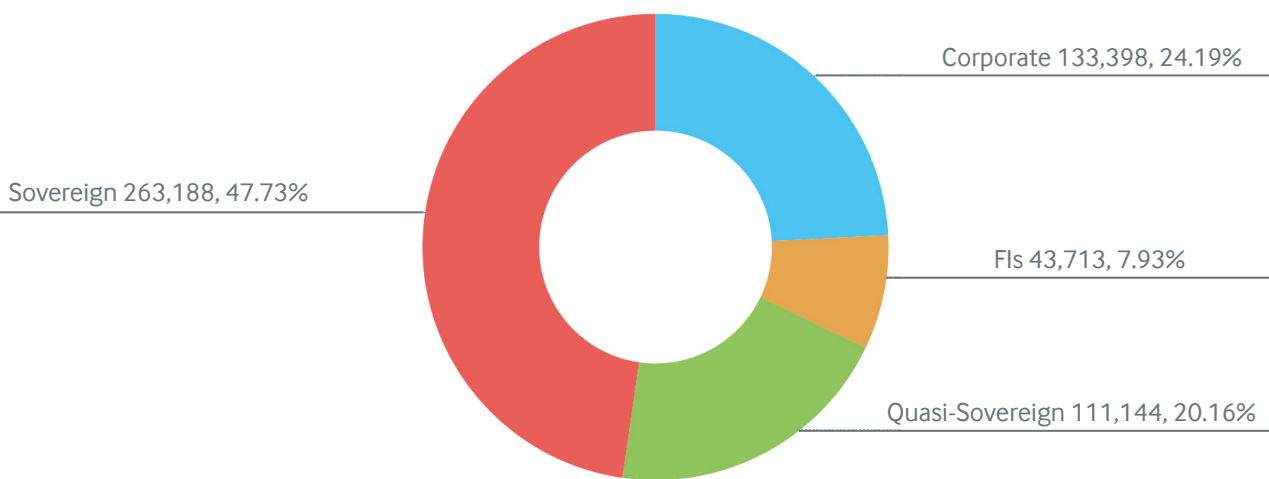
Total Global Sukuk Outstanding as of 31 December 2019



Source: Fitch Ratings, IIFM Sukuk database

According to the International Islamic Financial Market (IIFM), total outstanding sukuk issuance reached USD551.44 billion in 2019, compared to USD490.78 billion in 2018, recording the largest annual issuance since the inception of the international sukuk market in 2001.

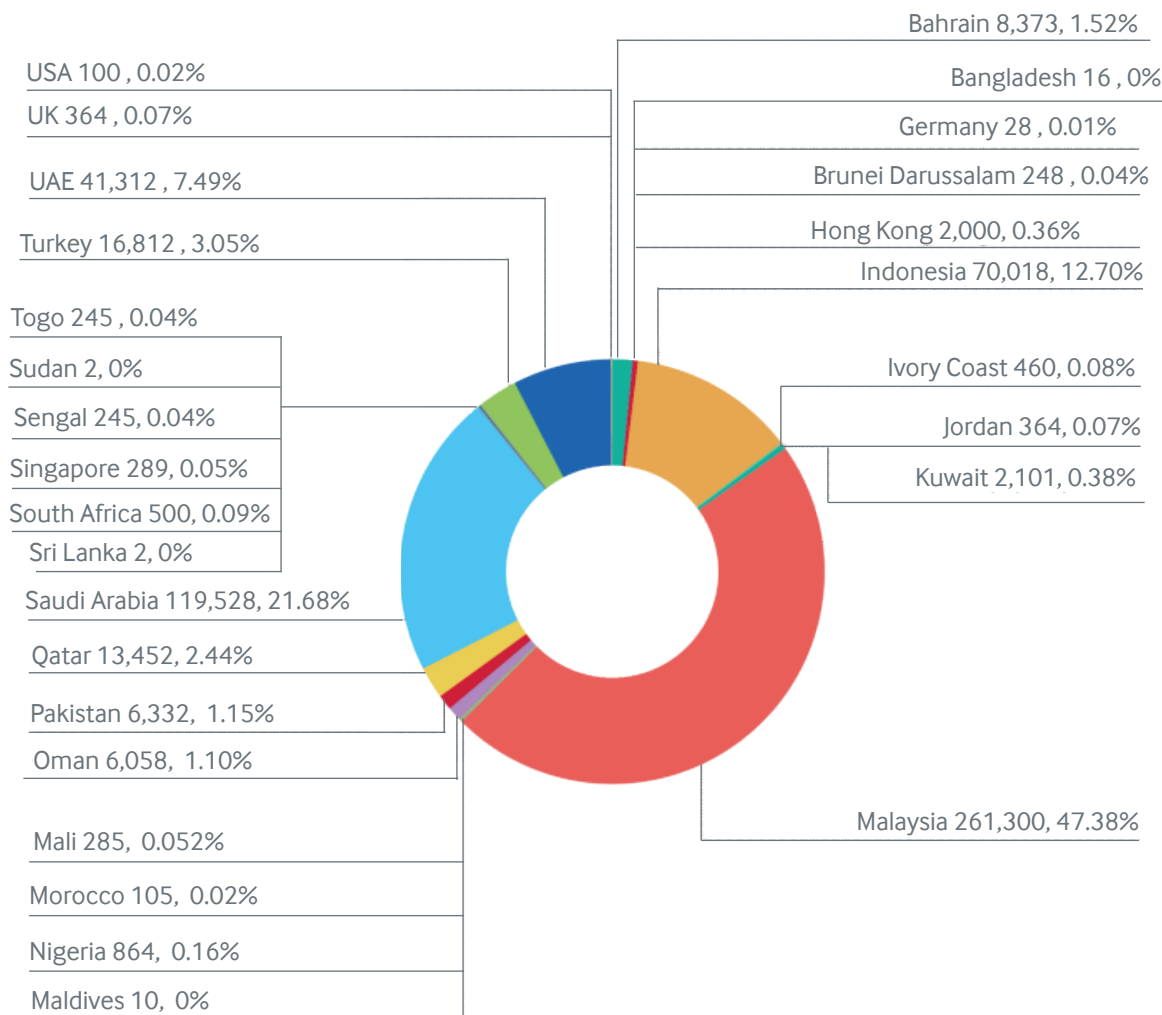
Total International Sukuk Outstanding by Type of Issuer as of 31 December 2019 (USD m)



Source: Fitch Ratings, IIFM Sukuk database

The sukuk market has also experienced several innovations, notably the launch of Formosa, Sustainable, Green and Hybrid Sukuk, which helped attract a wider investor base. Sukuk have typically been purchased by investors intending to hold-to-maturity, so the secondary market performance of sukuk has generally been more stable. Demand for new sukuk issuances continues to be strong, as evidenced by the extent to which deals have been oversubscribed in the primary market.

Total International Sukuk Outstanding by Issuer as of 31 December 2019 (USD m)



Source: Fitch Ratings, IIFM Sukuk database

Simplified Example of a Sukuk Transaction

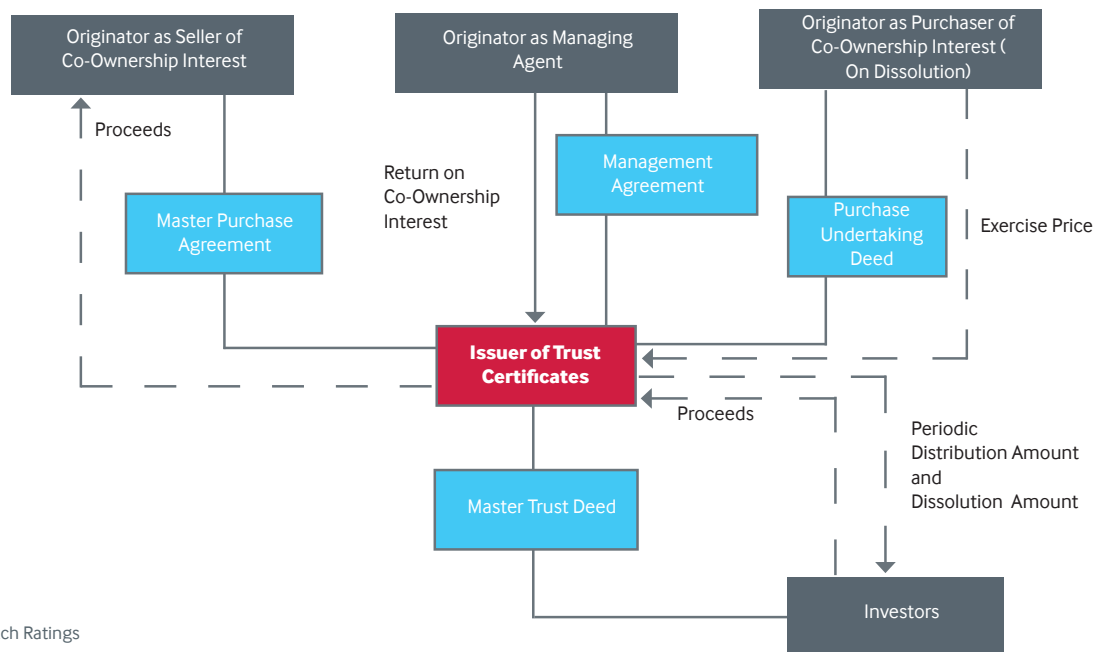
Sukuk do not have a standard structure and each structure can take a variety of forms that could affect their recourse, debt ranking, recovery upon issuer default and credit rating. However, the below can serve as an example.

In an international sukuk structure, an originator places well-defined, identifiable asset(s) into a single-purpose Special Purpose Vehicle (SPV), the shares of which are usually held in a trust (could be a charitable trust). It should be noted that the nature of the underlying assets will vary depending on the nature of the originator. For example, a sovereign or corporation may transfer just one or more tangible assets, such as real estate generating a rental stream, whereas an Islamic bank could also include a transfer of a financing transactions pool.

The assets are placed in a SPV to ensure that, when issuing the sukuk, the process results in a sharia-compliant transaction in which parties share the risks and rewards of a specific asset or asset pool (in the SPV). The SPV, in turn, makes a separate “declaration of trust” in favor of the sukukholders. This is sometimes called a “declaration of agency”, as the concept of a trust does not exist explicitly in sharia as generally understood in common law jurisdictions.

The SPV is the entity responsible for issuing the sukuk. Investors buy the sukuk certificates and make a principal payment to the SPV, which then uses the proceeds to purchase the assets from the originator. Under the documentation (i.e., agency agreement), the originator is responsible for managing the assets and transferring the income they generate to the SPV on a regular and timely basis. The SPV, in turn, distributes the profits among investors, based on their participation in the issuance.

Structure Diagram and Cashflows



The structure usually allows the originator to retain possession and control of the assets, making this entity responsible for maintaining the value of these assets at the same level they exhibited on the issuance date throughout the life of the sukuk. This could also include originator obligations to replacement of assets and providing insurance/takaful cover to underlying assets and covering any shortfall of insurance/takaful coverage. This minimizes disruptions in the originator's business and spares the SPV from getting involved in operational matters.

As mentioned above, investors are entitled to receive a proportion of the returns generated by the assets, which continue to be managed by the originator. Transaction documents typically indicate a benchmark rate of return. Upon maturity of the agreement, the originator is responsible for repurchasing the assets, which results in the return of the principal payment to investors.

While the investor participates in the returns generated by the underlying assets, the sharing of the risks associated with these has so far been contractually limited, as sukuk documents include mechanisms to pass these on to the originator rather than the investor. Sukuk contractual commitments include the timely, full payment of sukuk principal, as well as periodic distributions throughout the life of the sukuk and upon maturity or any dissolution or default event. Moreover, sukuk obligations rank equal to other unsecured obligations of the obligor, and default on these commitments can usually trigger and be triggered by other unsecured cross-acceleration/cross-default provisions.

The originator may provide a liquidity facility or a top-up mechanism to match receipts to the contractual periodic distributions and eliminate any volatility in the cash flows deriving from the assets. The documentation usually incorporates a purchase undertaking, whereby the originator is committed irrevocably to repurchase the assets upon maturity (or earlier, in the event of any dissolution or default by the originator or a total loss event), covering the outstanding principal and periodic distributions during the life of a sukuk or until any dissolution event takes place.

The basis on which the repurchase price is set may vary according to the sukuk structure. There has been a tendency among sharia scholars to push for the fair market value rather than a fixed amount (e.g., the original sale price) to be the benchmark for a repurchase on maturity or following an event of default. However, in most international sukuk the repurchase price is a fixed amount and hence is not subject to market risk.

Typically, sukuk are structured as entity credit-risk instruments without recourse to the underlying assets in a default and redemption scenario. Recovery is based on investors exercising their rights against the originator to purchase the assets pursuant to the terms of the purchase undertaking deed. The documentation will usually specify that the only recourse or contractual claim is against the originator, which places sukukholders in a position similar to that of bondholders under a conventional unsecured bond.

Non-payment would trigger an event of dissolution or default, which would require the payment of the outstanding principal amount, and any accrued but unpaid periodic distributions amounts by the originator. The purchase undertaking may be further reinforced by an explicit guarantee from the originator. It is, however, customary for the originator to guarantee the obligations arising from the underlying contracts (e.g., ijara or murabaha) rather than guaranteeing the SPV's obligation to pass payments through to sukukholders.

Warranties and waiver clauses related to the sharia-compliant nature of the sukuk, which aim to prevent an obligor from challenging the legitimacy and enforceability of the sukuk, have recently been enhanced and are becoming part of the sukuk documentation.

Covenants (Including Events of Default)

Documentation on sukuk has incorporated covenants, including events of default similar to those seen in conventional bond documentation. These include: failure to perform any obligations laid down in the agreements; failure to pay any amounts due (both

periodic distributions and repayment on maturity); failure to comply with any notices; unlawful actions; noncompliance with sharia and cessation of operations, insolvency, or any arrangements/deferment in relation to any indebtedness. These events of default may be reinforced by a negative pledge and cross-default clauses, which further link the performance of the originator and the sukuk.

Types of Sukuk Structures

Sukuk are typically structured to reflect the characteristics of traditional fixed-income products such as bonds but in a manner that is certified by scholars to be sharia-compliant.

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has specified different types of allowable sukuk. The choice of structure will depend on several aspects, including the type of underlying assets, taxation and regulatory considerations, the target investor base and the views of the sharia scholars who must approve the sukuk issuance.

The sukuk structures adopted in the Middle East can differ noticeably from those embraced in East Asia. There are many reasons for these differences, including the difference in the interpretation of sharia between Middle Eastern scholars and Asian scholars. Other reasons include different local laws and, more importantly, different tax treatments. For instance, in Gulf Cooperation Council (GCC) countries, income tax and VAT are almost absent and therefore sukuk structures are typically not tax-driven. This is not the case in East Asia and most other countries, where taxation could have a significant impact on structures.

Historically, the most common structures used in sukuk issuance have been ijara, mudaraba and musharaka. However, following the AAOIFI 2008 statement criticizing the use of fixed-price purchase undertaking deeds to guarantee returns in mudaraba and musharaka sukuk structures, ijara and al wakala or hybrid contracts became the most commonly used sukuk structures.

The following is an overview of the underlying structures most commonly used in sukuk issuance. Sukuk may incorporate one or more structures, for example ijara and murabaha. Financial institution (FI) sukuk tend to be based on a pool of transactions, while corporate and sovereign sukuk are generally based on returns from tangible assets, such as real estate. The terms musharaka, mudaraba, ijara and wakala are broadly used in sukuk structures, but the actual legal structure can differ considerably from these.

1) Ijara

The ijara structure resembles a conventional lease agreement, and while there are some technical differences in terms of asset ownership and interest penalties, it is similar to a lease agreement in terms of how it functions, with the owner of the asset leasing it to a third party in exchange for a specified rental payment. Ijara contracts are similar to a conventional lease in so far as they reflect the concept of “usufruct” (i.e., the right to use the asset).

However, unlike conventional lease agreements, if a lessee is late making a payment, lessors cannot impose any penalty, as any additional gain for the owner would be deemed unfair to the lessee. However, in that situation, the lessor may impose a late payment fee to be paid to a charity of the lessor’s choice. This gives the lessee motivation to comply with the lease.

The lessor retains ownership of the leased asset until maturity of the transaction, when ownership is ordinarily transferred to the lessee. The lessor usually appoints the lessee as his agent to manage the asset, which allows the lessee to make full use of the asset and minimize interruption to his business. As a matter of sharia, however, the lessor is responsible for major maintenance of the leased assets to ensure that

they are in working order, although these responsibilities will typically be delegated to the lessee.

2) Wakala

A wakala is an agency contract between an investor (muwakkil), typically a financial institution, and the agent (wakil), the entity requiring financing. It is typically used in interbank arrangements and between group companies. In sukuk, it is not always possible to identify a tangible asset of sufficient value that can be used for the purposes of sukuk issuance.

In a basic sukuk-al-wakala, it is permissible for the originator to bundle its underlying investments and sell them to the issuer in return for a purchase price. An Islamic financial institution is therefore able to bundle, for example, its ijara contracts, murabaha receivables and any shares or sukuk certificates held by it into a portfolio, which is then sold to investors. The income derived from the portfolio is used to service the coupon payments due under the sukuk certificates. Although the wakil can be any entity, the investments made by the wakil have to be sharia-compliant. In each case, the wakil will charge a nominal fee for providing its expertise.

3) Mudaraba

The investor or FI entrusts funds to a corporation, which utilizes these funds in a pre-agreed investment or business. After the operation is concluded, the company returns the principal and the pre-agreed share of the profit. The company retains the remaining profits from the business. Conversely, the investor or FI also participates in any potential losses and is faced with the prospect of losing the original principal investment. The company does not share in the losses beyond its own investment and the time and effort put into the business venture, provided fraud or negligence cannot be proven.

4) Al-Musharaka

This type of partnership is similar to mudaraba, except that under musharaka the investor or FI takes an equity stake in the venture. Such an arrangement is similar to venture capital financing, where the investor or FI sometimes participates in the management of the business or project. Profits are divided on a pre-arranged basis, and any losses are shared in proportion to the capital owned.

5) Istisna’a

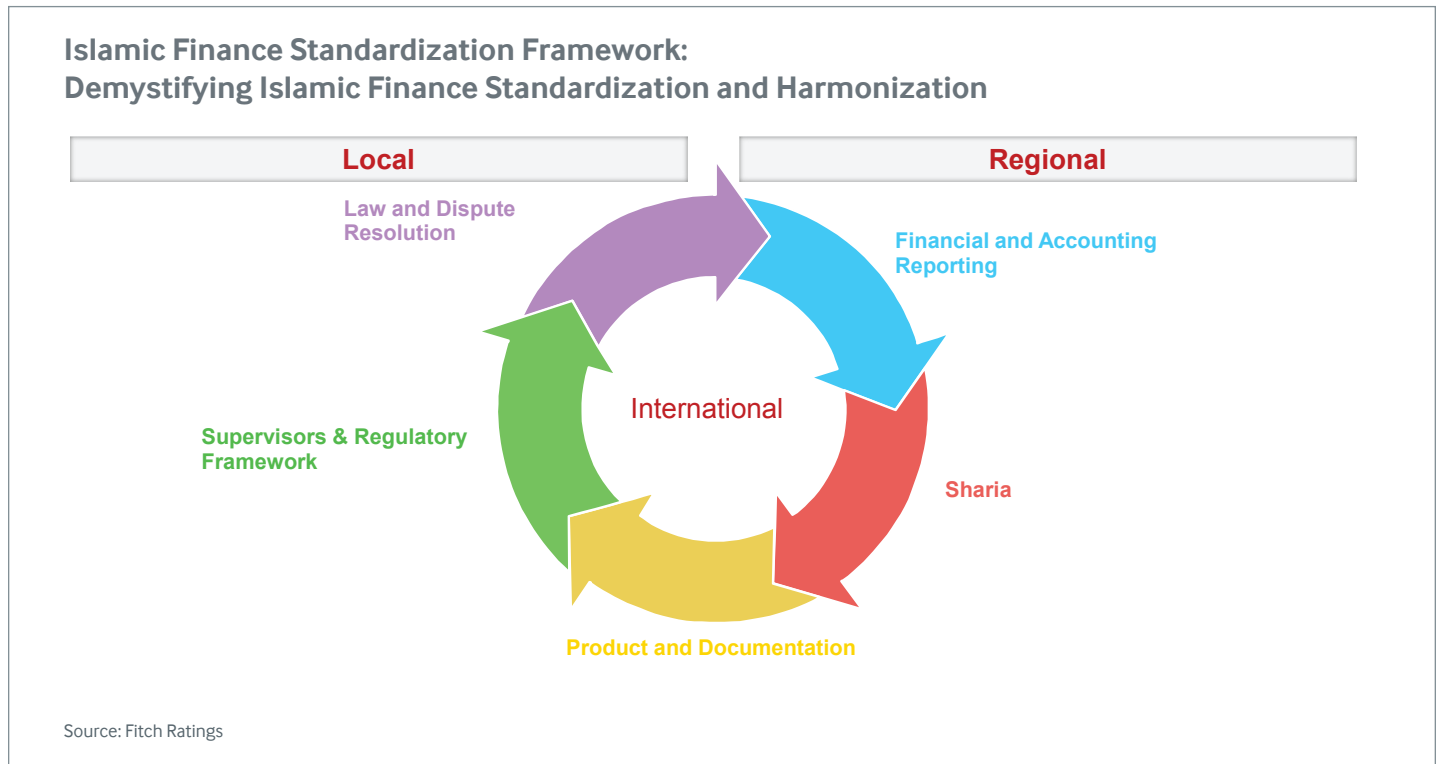
Istisna’a is a form of financing under which a financier commissions the construction or manufacturing of an asset. The financier provides specifications for the asset (e.g., a power plant, a factory or machinery), but in practice the specifications are generated by the obligor, who will usually understand the technical and commercial requirements better than the financier. The financier makes one or more down payments for the asset and agrees to purchase it when it is delivered. Meanwhile, the financier and the obligor enter into a forward ijara (lease) agreement. The combination of istisna’a and ijara thus provides for advances to finance the construction/manufacturing phase and subsequent use with settlement by instalments. The documents usually provide for the unwinding of the forward lease arrangement if completion of the asset is not achieved.

6) Murabaha

Murabaha is the sale of an agreed asset or commodity at cost plus an agreed profit margin, which may then be financed in installments. Banks also use this as a means of providing liquidity to their customers, by (a) buying the assets, (b) selling them to the customer at a mark-up, whilst giving the customer a period of time in which to pay the purchase price and mark-up and (c) the bank will be assigned as the customer’s agent, who will then sell the assets in the marketplace and credit the proceeds of the sale to the customer’s account, thereby providing liquidity.

Challenges to the Development of the Sukuk Market

Standardization: The Islamic finance industry is challenged with the lack of standardization. Standardization will help boost sukuk issuance volumes through faster and less costly issuance processes. The main areas where standardization would be advantageous include product and documentation, sharia interpretation, supervisors and regulatory framework, law and dispute resolution, and financial and accounting reporting.



While sharia scholars agree on its main principles, there are differences in interpretation between the various schools of Islamic religious scholarship and between scholars of different jurisdictions. This can go as far as one sukuk financing syndication having two sharia tranches and one conventional tranche, as the participating Islamic banks may not agree with each other's fatwas (ruling on a point of Islamic law given by a recognized authority).

The Malaysian government has attempted to address the issue of standardization at a national level by establishing a Centralized Sharia board to ensure that every sukuk issued in Malaysia is in full compliance with nationally accepted sharia principles. In the GCC region, the UAE is also progressing in this regard, with the establishment of the Higher Sharia Authority (HSA) at the Central Bank of the UAE. The fatwas and opinions issued by the HSA are binding on internal sharia supervisory committees of Islamic banks in the UAE.

Furthermore, standards in regulatory and legal areas that aim to describe rights and obligations under all circumstances would support consistency, strengthen supervision and enable the industry to move to the next phase of its development. This would be particularly important for driving corporate sukuk issuance locally, regionally and internationally, as the market is currently dominated by sovereign issuance.

Industry groups, such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB), are expanding and developing standards to best achieve harmonization in several areas, including sharia and financial reporting.

However, progress has been slow and the industry is not even close to achieving international or regional standardization. Nevertheless, the industry has developed notably in certain areas. To illustrate, 16 years ago it would have taken months to issue a sukuk offering, whereas now it takes only weeks.

Sukuk Default Resolution: Bankruptcy regimes in many key sukuk-issuing jurisdictions are still in the early stages of development, remaining largely untested and underdeveloped. In the event of sukuk default, recovery from sukuk could be harder than from conventional bonds due to sharia requirements and the fact that sukuk in their legal form are very different from conventional bonds. Due to the lack of legal precedents, it remains to be seen how bankruptcy courts in key Islamic finance jurisdictions treat sukuk relative to conventional bonds in the event of default.

The cross-border feature of international sukuk can also add to their legal risk and complexity. While most sukuk issued on the international capital markets are typically governed by English law and subject to the jurisdiction of the courts of England (or other recognized international law and jurisdiction), part of the documentation is governed by local courts in the originator's domicile. As foreign court judgements are not enforceable in most sukuk-issuing jurisdictions, this could lead to a situation where an English court ruling in favor of investors will still need to go before a local court, which may or may not recognize the foreign court's ruling.

Fitch Ratings' Islamic Finance Coverage

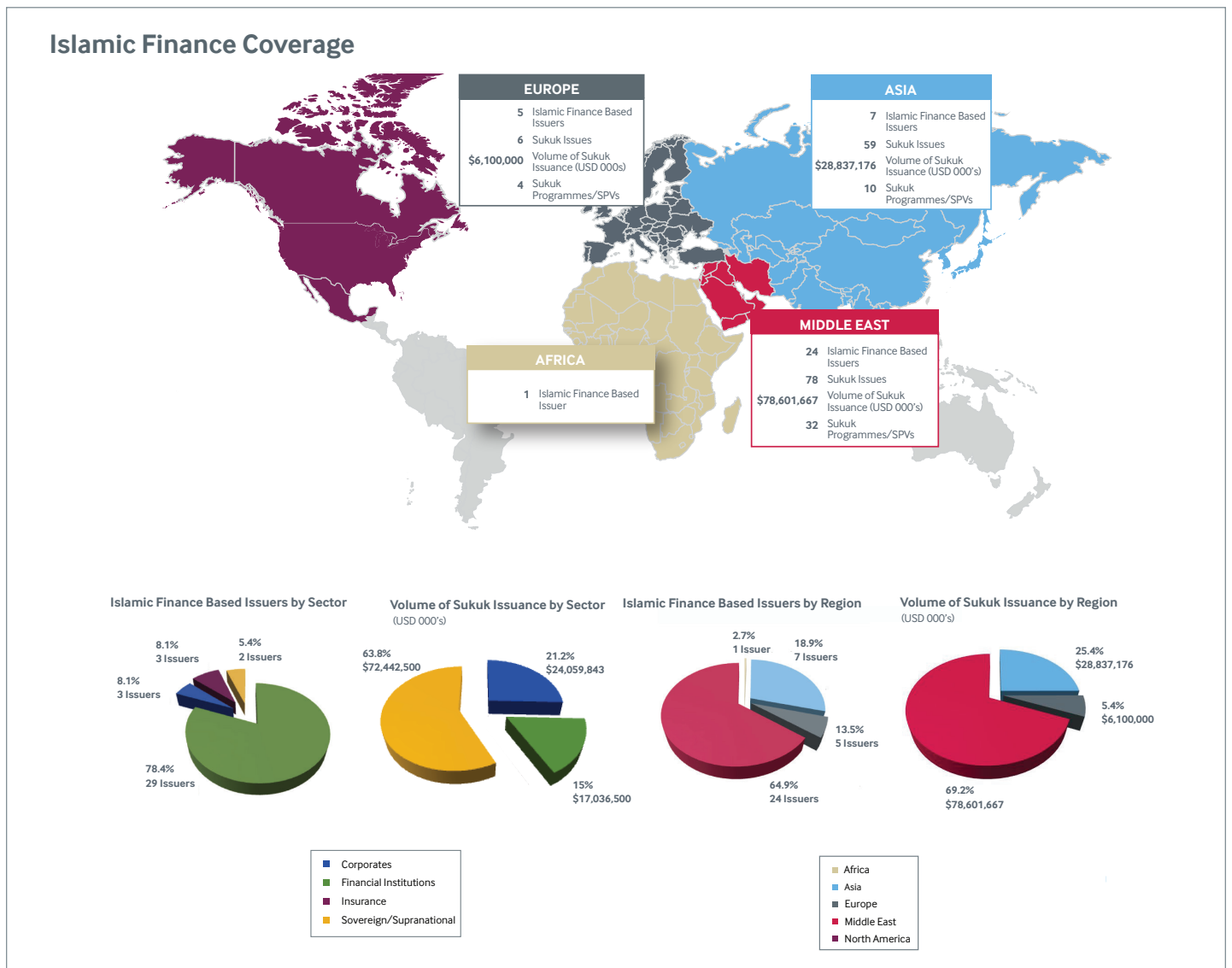
At Fitch Ratings, we have been providing independent and objective credit ratings to the Islamic Finance market for over a decade. With a strong track record in Islamic Finance, we rate more Islamic banks than any other global credit rating agency. We currently rate over 140 outstanding Islamic Finance instruments worldwide, more than 35 Islamic Finance issuers and over USD113 billion in outstanding sukuk as of 2020.

- Fitch rated Islamic Development Bank's first Sustainability Sukuk in 2020, which was issued to help member countries tackle the aftermath of the COVID-19 pandemic.
- Fitch was assigned to rate DP World's hybrid sukuk in 2020, which is the first rated corporate hybrid sukuk.

Fitch's landmark engagements include the below:

- Fitch rated the world's first Sovereign Green Sukuk issued by Indonesia in 2018, and its follow-up issuances in 2019 and 2020.
- Fitch rated the world's first Formosa Sukuk issued by Qatar Islamic Bank in January 2020.
- Fitch rated the world's first benchmark Corporate Green Sukuk issued by Majid Al Futtaim in 2019.

Fitch's Islamic Finance Group coordinates all Islamic Finance activities and expertise across the Sovereign, Financial Institutions, Corporates, Structured Finance, Infrastructure, and Insurance teams. In addition to being involved in the ratings process of Islamic Finance instruments, the group monitors and reports on this rapidly-growing sector through specialised research and commentary as well as the development of criteria. The Islamic Finance team spans various continents and time zones and brings a combination of local knowledge, as well as a strategic global perspective to this evolving sector.



Fitch's Islamic Finance Rating Approach

1) Fitch's Approach to Rating Sukuk

Fitch has dedicated Sukuk Rating Criteria which describe Fitch Ratings' approach to assigning and maintaining ratings for new and existing originator-backed sukuk issues. These criteria apply to originator-backed (or "asset-based") sukuk structures, where investors rely upon obligor-direct support features and contractual commitments built into the documentation. These criteria apply globally to corporates, financial institutions, sovereigns, supranationals, public finance, insurers and global infrastructure. They do not apply to asset-backed sukuk, which rely on underlying collateral.

It is also possible for sukuk to be structured as subordinated, short-term or secured claims. If so, they will be rated as such in accordance with Fitch's established criteria, with the ratings again benchmarked to the Issuer Default Rating (IDR) or the issuer's Viability Rating (VR) where the case dictates.

Key Rating Drivers:

1. Ratings Anchored on Issuer Default Ratings (IDRs)
 - Fitch looks through the structure of the sukuk at the obligor/originator/issuer of the transaction.
 - Sukuk often require the creation of a special-purpose vehicle.
 - The ratings are benchmarked to the ratings of the originators.
2. Full Recourse to Originator
 - As with a conventional bond issue
3. Sukuk Form Affects Rating
 - Forms could affect sukuk recourse, debt ranking, recoveries upon issuer default, and ratings.
4. Legal Risk
 - Uncertain enforcement in many jurisdictions where sukuk issuance is prevalent.
 - These risks also apply to conventional bonds issued in the same country; already reflected in the IDR of the originator.
 - Fitch's ratings exclude any opinion on compliance with sharia law.

Transaction Specific Disclosure:

In its Rating Action Commentaries (RACs), Fitch expects to disclose the following:

- Rationale for the rating action,
- Rating anchor,
- Recourse to originator/obligor,
- Asset recourse: usually no recourse (disclosed either way),
- Key transaction parties, the mechanics and who will pay the sukuk principal, income and servicing during the life of the sukuk, and in a dissolution event (or earlier, in the event of any dissolution or default by the originator or a total loss event),
- Sukuk ranking (senior, subordinated or pari passu with other obligations),
- Sukuk terms and conditions,
- Sukuk ratings do not imply any confirmation that the sukuk are sharia compliant,
- Identify any sharia and/or legal limitation.

Any variations will be disclosed in the Rating Action Commentaries, including their impact on the rating where appropriate. Fitch may not disclose the same assumptions in subsequent commentaries, unless there are material changes.

For more information on Fitch's Sukuk Rating Criteria, please click [here](#).

2) Fitch's Approach to Rating Islamic Banks

Fitch Ratings acknowledges that there are important differences between Islamic and conventional banks that must be considered. These include approaches to risk management, funding, liquidity, legal issues and regulatory oversight. They also include transparency/disclosure, accounting standards, corporate governance and support. However, Fitch does not use a separate credit rating methodology or rating scale for Islamic banks, as these differences can be incorporated within the existing bank rating framework. Islamic bank ratings do not express an opinion on a bank's compliance with sharia, but Fitch will assess non-compliance with sharia if it has credit implications.

Key Rating Drivers:

1) **Framework Reflects Bank Specifics:** The ratings assigned to banks reflect the specific drivers (components) of bank credit. Viability Ratings (VRs) capture a bank's intrinsic creditworthiness, while its Support Rating (SR) and Support Rating Floor (SRF) reflect the likelihood of it receiving external support in case of need. A bank's Issuer Default Ratings (IDRs) and issue ratings are derived from the VR and support ratings.

2) **"Higher Of" Approach for IDRs:** Fitch generally adopts a "higher of" approach in assigning banks' Long-Term IDRs. We determine the IDR a bank could attain based solely on its stand-alone financial strength (as

reflected in its VR), or based solely on external support, and then assign the IDR at the higher of these levels. In rare cases, for example where senior creditors are protected by a large junior debt buffer, IDRs may be notched up from VRs. Bank IDRs usually rate to default risk on senior obligations to third-party, non-government creditors.

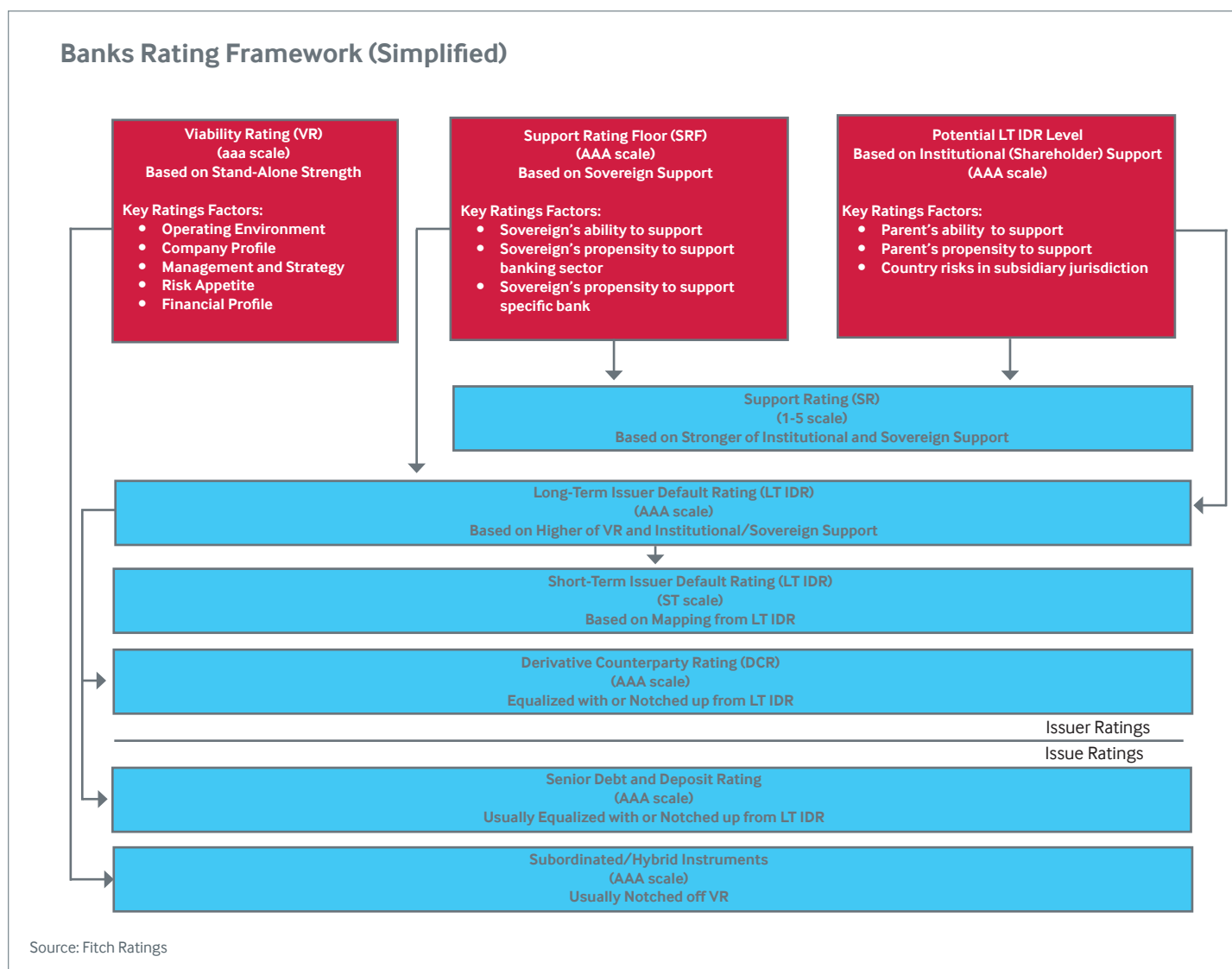
3) **VRs Based on Five Factors:** In assessing a bank’s standalone creditworthiness and assigning its VR, Fitch considers five key factors: the operating environment; company profile; management and strategy; risk appetite; and financial profile. Each factor is broken down into several sub-factors. VRs rate to the risk that a bank will fail, i.e. either default or need to receive extraordinary support/impose losses on subordinated obligations to restore its viability.

4) **Institutional and Sovereign Support:** A bank’s SR reflects Fitch’s view about the likelihood that the entity will receive extraordinary support if needed. Support typically comes from either a bank’s shareholders (institutional support) or the national authorities of the country where the bank is domiciled (sovereign support, also reflected in the SRF). Fitch considers both the ability and propensity of the potential supporter to provide assistance.

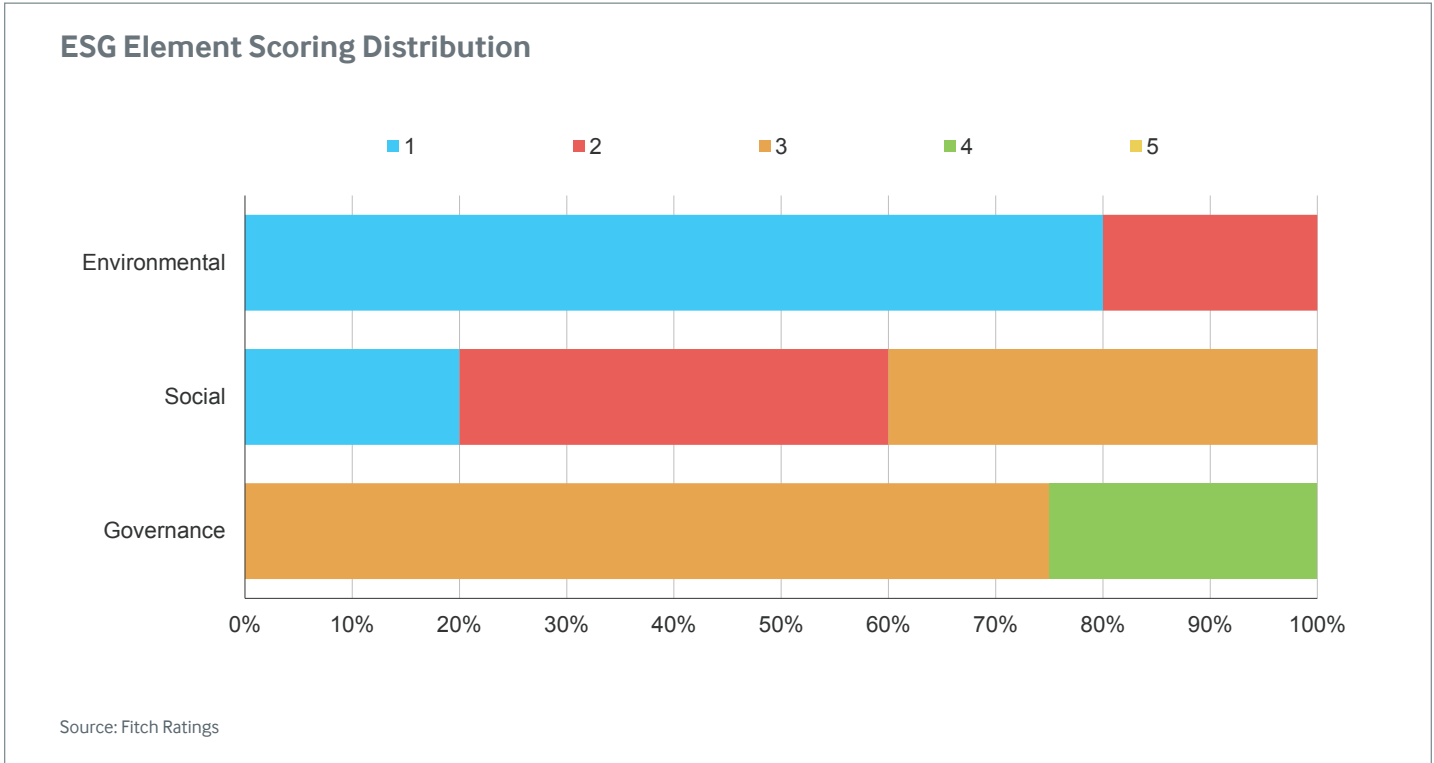
5) **Default Risk, Recovery Prospects:** Long-term issue ratings of banks, in common with other corporate finance sectors, reflect Fitch’s view of the overall level of credit risk attached to specific financial commitments, usually securities. This view incorporates an assessment of the likelihood of default (or “non-performance” risk) on the specific obligation and a view of potential recoveries for creditors in the event of default/non-performance .

6) **Debt Ratings:** Senior unsecured obligations are usually rated in line with a bank’s Long-Term IDR if the default risk is aligned with the risk captured by the IDR. However, they could be notched up (for example, where one class of senior debt is offered protection by another) or down (for example if recoveries are likely to be weakened by deep effective subordination). Subordinated and hybrid debt is typically notched off the obligor’s VR, with notching dependent on the extent of incremental non-performance risk (relative to the risk of failure) and recovery prospects in the event of default.

For more information on Fitch’s Bank Rating Criteria, please click [here](#).



ESG Consideration for Rating Islamic Banks: In 2019, Fitch Ratings launched Environmental, Social and Governance (ESG) scores for Islamic banks, which captures heightened reputational risk compared to their conventional peers, defined by sharia principles due to the nature of their business. Any significant operational issues, either in terms of sharia non-compliant financial products or disclosures, may cause reputational impact. These issues are captured under Fitch’s ESG framework. The Governance Structure relevance score for Islamic banks is 4, in contrast to the typical ESG relevance score for comparable conventional banks is 3. In addition, Islamic banks have an Exposure to Social Impacts score of 3, in contrast to a typical ESG relevance score of 2 for comparable conventional banks.



ESG Scoring Definitions

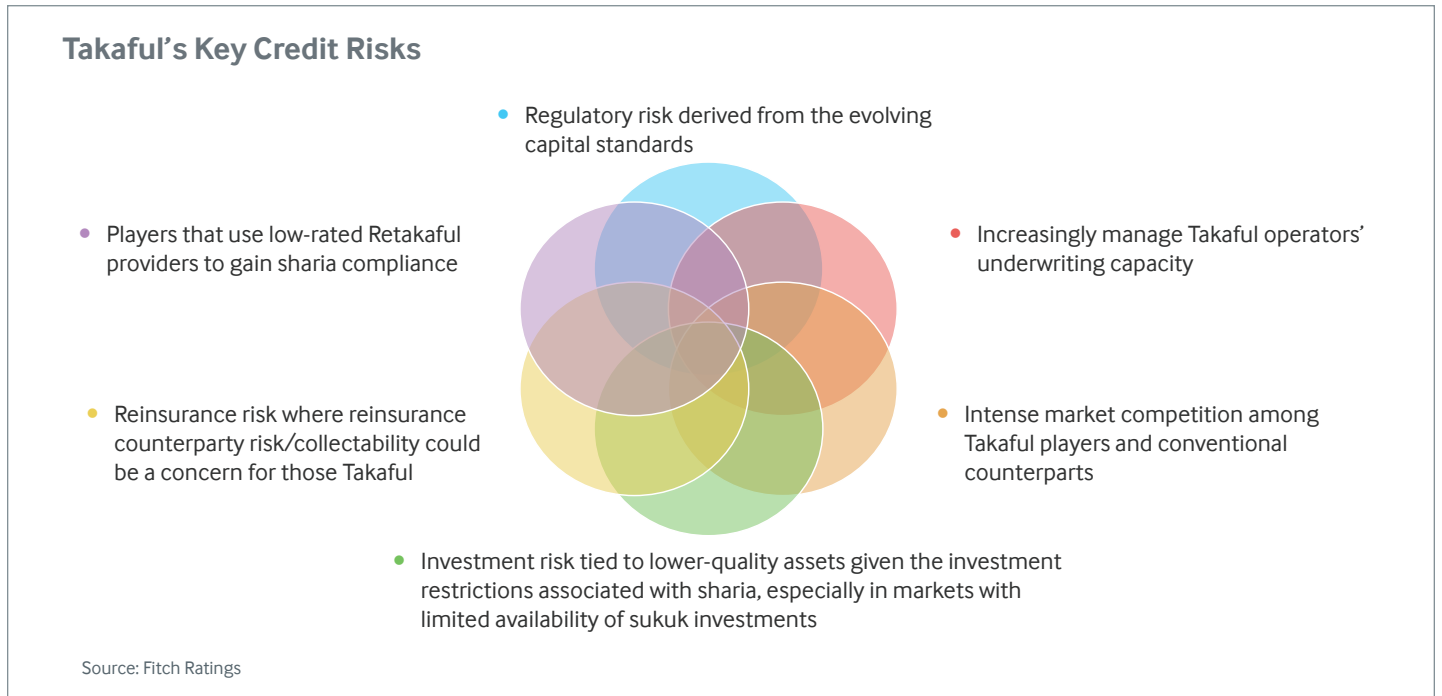
Lowest Relevance		Neutral	Credit-Relevant to Issuer	
1	2	3	4	5
Irrelevant to the entity’s rating and irrelevant to the sector.	Irrelevant to the entity’s rating but relevant to the sector.	Minimally relevant to the rating, either very low impact or actively managed in a way that results in no impact on the entity’s rating.	Relevant to the rating, not a key rating driver but has an impact on the rating in combination with other factors.	Highly relevant, a key rating driver that has a significant impact on the rating on an individual basis.

Source: Fitch Ratings

For more information on Fitch’s ESG Relevance Scores, please click [here](#).

3) Fitch's Approach to Rating Takaful

Takaful are type of insurance companies that comply with Islamic principles, unlike conventional insurance companies. Takaful institutions are rated under the Insurance Rating Methodology, but there are some specific considerations under the methodology, including some of Takaful's Additional Key Credit Risks. Since takaful operators do not have a standard global operating model, each structure is reviewed individually by Fitch, including transferability, accessibility of funds, loss bearing features, fees and split of surplus among Takaful fund(s).



For more information on our Insurance Rating Criteria, please click [here](#).

What to Watch in Islamic Finance

Global Sukuk Market Dashboard: 2Q20

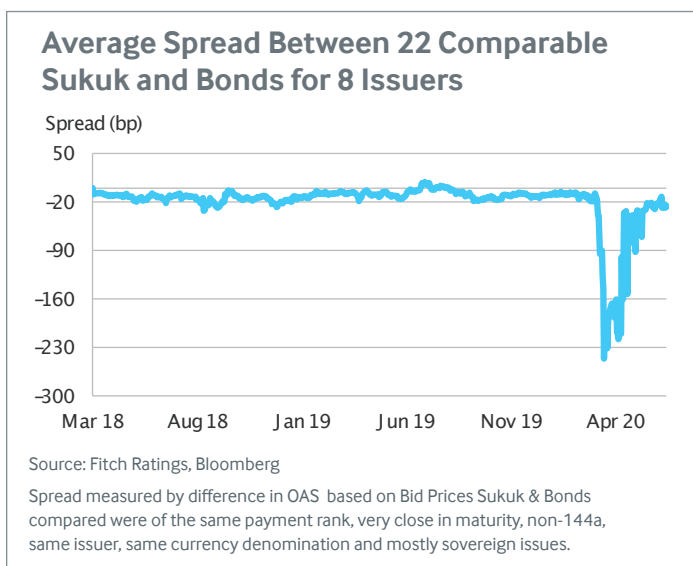
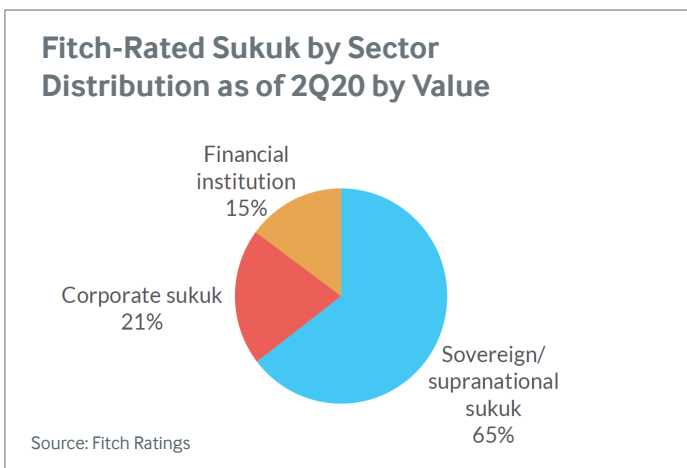
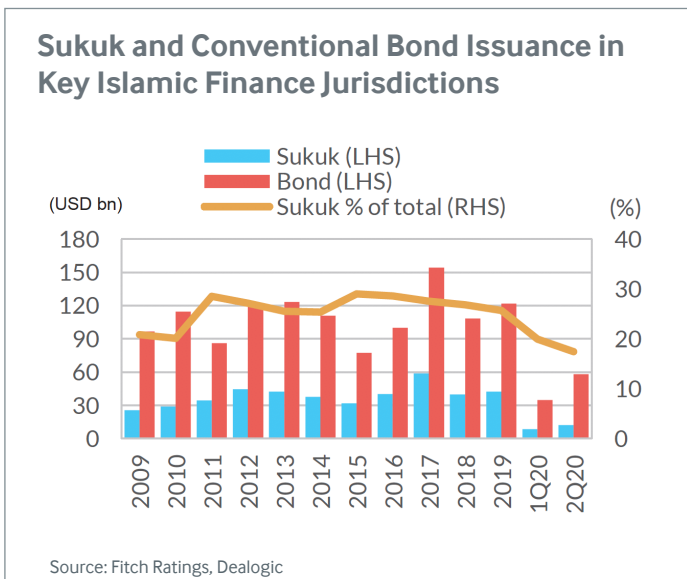
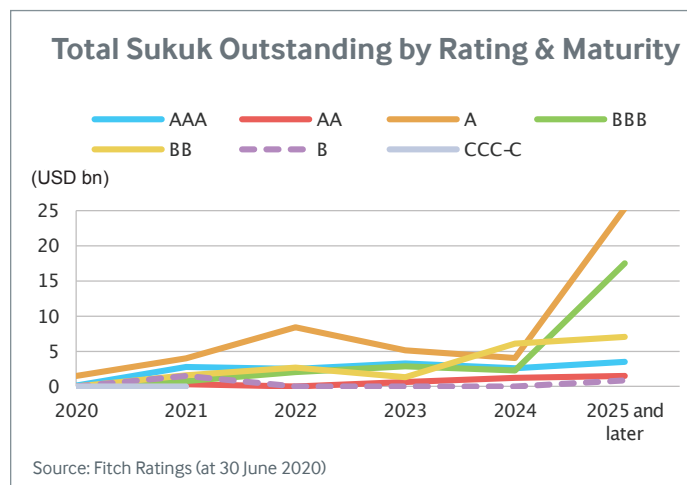
Sukuk Markets Experience Strong Pick Up After Coronavirus-Related Slowdown

The market activity of sukuk issuance, which almost came to a standstill in March-April 2020 due to the fallout from the coronavirus, has resumed in 2Q20, similar to levels seen in the first two months of the year. This could indicate that both issuers and investors have readjusted their investment and funding strategies to reflect the new norm. In 1H20, there have also been innovative issuance trends like Formosa, sustainable, green and hybrid sukuk, which helped attract a wider investor base.

Sukuk Market Profile: Sukuk issuance with a maturity of more than 18 months from the Gulf Cooperation Council (GCC) region, Malaysia, Indonesia, Turkey and Pakistan reached USD12 billion in 2Q20, 42% higher than 1Q20. The volume of outstanding Fitch-rated sukuk reached USD114.5 billion at end-2Q20, of which about 25% is estimated to mature in 2020-2022. About 82% of issues are investment-grade and 18% are speculative-grade.

Rising Issuer Needs: Sovereigns in key Islamic finance jurisdictions, many of whom are net oil exporters, are expected to increasingly issue sukuk and bonds to fund rising fiscal deficits due to oil price falls and coronavirus-related economic disruptions. Financial institutions in the GCC are mainly deposit-funded, but they are expected to continue issuing sukuk and bonds to diversify their funding sources and benefit from low funding cost. Issuances by corporates are also set to expand as banks become more selective in their lending.

Intact Investor Appetite: Since April 2020, many Fitch-rated sukuk have been oversubscribed multiple times. In search for higher yields, European and American investors have also held sizeable long positions in sukuk. However, investors are selective towards investment-grade credits as markets have been very volatile.



Sukuk Pricing Anomaly: Historically and during normal market conditions, the pricing of comparable sukuk and bonds are strongly correlated to each other and the average spreads between them are low. However, from mid-March onwards, emerging markets (EM) have increased capital outflows, corresponding to the period of coronavirus-related lockdowns in the GCC. During the period, sukuk were sold at steeper discounts than comparable conventional bonds as indicated by their spreads and correlation falling sharply in March & April.

This was largely due to sukuk markets being very concentrated, less liquid and much smaller than bond markets. Additionally, banks in the UAE, Saudi Arabia and other GCC countries, which are sizeable sukuk investors, faced heightened liquidity needs. However, after regulators implemented measures to unlock banking sector liquidity, sukuk and bonds' spreads and correlation began to normalise to prior levels.

Sector Outlook: Sukuk issuance is expected to rise in the short and medium term, as sovereigns, financial institutions and corporates diversify their funding and take advantage of low funding cost. Investors are expected to continue seeking higher yields in EM, where key sukuk-issuing jurisdictions are domiciled. However, investors will remain focused on issuers with strong credit fundamentals.

Strong Sovereign Support Continues to Drive Most Islamic Bank Ratings

Fitch Ratings-London-18 August 2020: The Issuer Default Ratings (IDRs) of Islamic banks in the Gulf Cooperation Council (GCC) region are all investment grade, Fitch Ratings says, with 89% of IDRs driven by potential sovereign support either directly or through a parent. The remaining 11% are driven by banks' standalone creditworthiness, as defined by their Viability Ratings (VRs).

The Outlooks on most IDRs are Stable. Sovereign willingness to provide support has remained extremely strong throughout the GCC and little progress towards resolution has been made.

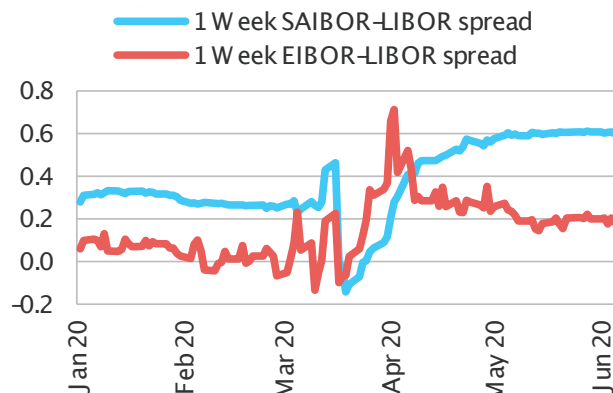
Only 35% of VRs are investment grade (this is lower than for conventional banks), with higher risk appetites and weak asset quality as the main shortfalls. The average VR in Saudi Arabia is a strong 'bbb+' (ranging from 'bb+' to 'a-') but is much weaker in Kuwait (bb+) and the UAE (bb). The average VR is 'bbb-' in Qatar. Increased sharia-focused regulation could potentially have credit implications, which we will assess as implementation progresses.

The two largest Islamic banks are in Saudi Arabia, reflecting Saudi Arabia's larger economy, well-established Islamic banking market and relatively small number of banks. The third-largest bank by assets, Kuwait Finance House (KFH), is well behind (about half the size). However, KFH could fill the gap if the discussed merger with Bahrain's Ahli United Bank goes ahead.

Islamic banks continue to benefit from strong demand for Islamic banking products now that these products are broadly equivalent to those of conventional banks. Some of these banks are in start-up or growth phases and are looking to gain market shares.

The full report "GCC Islamic Banks 2020 Compendium: Strong Sovereign Support Continues to Drive Most Islamic Bank Ratings" is available at www.fitchratings.com or by clicking [here](#).

1 Week EIBOR-LIBOR & SAIBOR-LIBOR Spread



Source: Fitch Ratings

Money Market Fund Sukuk Default Puts Regulation in Spotlight

Fitch Ratings-London-14 July 2020: The reporting of a sukuk default by a Saudi Arabia-domiciled money market fund (MMF) in May underscores that MMF risk profiles can be highly influenced by investment guidelines and country-specific regulation, Fitch Ratings says. The importance of this point is amplified by the stressed operating environment, which could lead to increased defaults in lower credit quality instruments potentially held by MMFs.

Saudi MMFs differ from European and U.S. funds in that they can buy long-term assets such as sukuk, despite being short-term vehicles. European and U.S. MMFs typically cannot invest in securities with residual maturity of more than 397 days. Saudi regulation requires funds to maintain "a foreseen average of the date of maturity not exceeding 120 calendar days". This matches the weighted average life limit for European and U.S. funds but the regulation does not prescribe maximum individual asset maturities, with the result that funds can have exposure to longer-dated instruments. Furthermore, Saudi regulation does not prescribe minimum credit quality standards. When rating MMFs, Fitch assesses managers' credit monitoring capabilities and continually reviews portfolios' credit quality.

The sukuk default resulted in a 6.7% one-day decline in the fund's unit price and the fund's net asset value subsequently decreased by 18% from 21 May to 30 June, largely driven by outflows. Fitch does not rate the fund and the defaulted sukuk is not identified in the fund's public disclosures. The default could weaken investor sentiment towards Saudi MMFs and may put pressure on other funds to review and strengthen their credit standards.

The default does not appear to have affected other Saudi MMFs, so far. Their disclosures do not indicate any exposure to the defaulted issuer and their performance metrics do not suggest any material adverse effects. The affected fund is relatively small. Its assets under management (AUM) were SAR667 million at the point of default, compared with Saudi MMF sector AUM of SAR128 billion at end-May 2020.

Saudi MMFs have had strong inflows this year (see [MMFs Central to AUM Divergence in Major Islamic Fund Domiciles](#)). Saudi Arabia is the GCC's largest and longest-established MMF market, with the first local fund launched in 1987. The only other GCC countries with locally domiciled MMFs are Kuwait and Oman, although other GCC countries have registrations from offshore MMFs, most of which are European.

Defaults in securities underlying MMFs are rare globally, particularly for MMFs operating in conservatively regulated environments or adhering to conservative investment guidelines. The most notable default to which MMFs were significantly exposed was the collapse of Lehman Brothers in 2008 during the global financial crisis. Since then, Fitch is aware of only two credit events affecting MMFs - one in South Africa in 2014 and the other in China in 2019.

Several South African MMFs had exposure to African Bank securities, which were subject to an instantaneous 10% write-down when the bank was put into curatorship in August 2014 (see [Fitch: Limited Effect of African Bank on South African Money Market Funds](#)).

Several Chinese MMFs had exposure to Baoshang Bank securities in early 2019, according to their 1Q19 disclosures. The bank was seized by local regulators in May 2019 but it is not clear whether the funds still had exposure at that point or whether they experienced losses as a result (see [Baoshang Seizure Highlights Risks at China's Small Banks](#)).

Regulatory Developments to Drive Takaful Growth in Malaysia

Fitch Ratings-Jakarta-19 February 2020: The creation of an Islamic finance-enabling ecosystem is the key driver of the Malaysian takaful industry's growth, Fitch Ratings says. This makes Malaysia a leading model for the sector, especially in light of the Muslim-dominated make-up of the untapped population segment. Increasing product awareness is also a factor towards improving market penetration as almost half of the Malaysian population does not have protection due to a lack of awareness on the comprehensive range of solutions offered by the takaful industry.

The takaful sector continues to enjoy faster growth than the conventional insurance sector, driven by stable domestic consumption and increasing consumer awareness. Family and general takaful premiums rose by 29.6% and 16.4%, respectively, in 1H19, compared with 12.2% in conventional life and -1.3% in general insurance, respectively. The sector also continues to gain share in the domestic insurance market, with family takaful accounting for 35% of the overall life market based on new business premiums in 1H19 (2018: 32%). General takaful accounts were 16% of the overall general insurance market (2018: 14%).

The increasing use of digital applications can also be a growth catalyst for the takaful industry. Virtual or peer-to-peer takaful providers that are tech-enabled may allow takaful companies to provide services at a lower cost, and be more flexible and customer-centric while also penetrating new areas.

Fitch thinks the removal of limits on commission and agency expenses for investment-linked takaful products, which came into effect in January 2020, will provide flexibility for takaful operators to manage their operating expenses and encourage greater competition. Nevertheless, takaful companies continue to face uncertainty over the interpretation and application of IFRS 17 to their business as the implementation deadline of January 2021 draws nearer. The selection of measurement models and treatment of various funds will have to be resolved.

The full report "Malaysia Takaful Dashboard: 2020" is available at www.fitchratings.com or by clicking the link in this [press release](#).

Formosa Sukuk Could Help GCC Issuers to Diversify Their Funding

Fitch Ratings-Dubai/London-03 March 2020: The expansion of Taiwan's Formosa bond market to include sukuk instruments could help Gulf Cooperation Council (GCC) issuers, including Islamic banks, to diversify their funding and widen their investor pool without increasing currency risk, Fitch Ratings says.

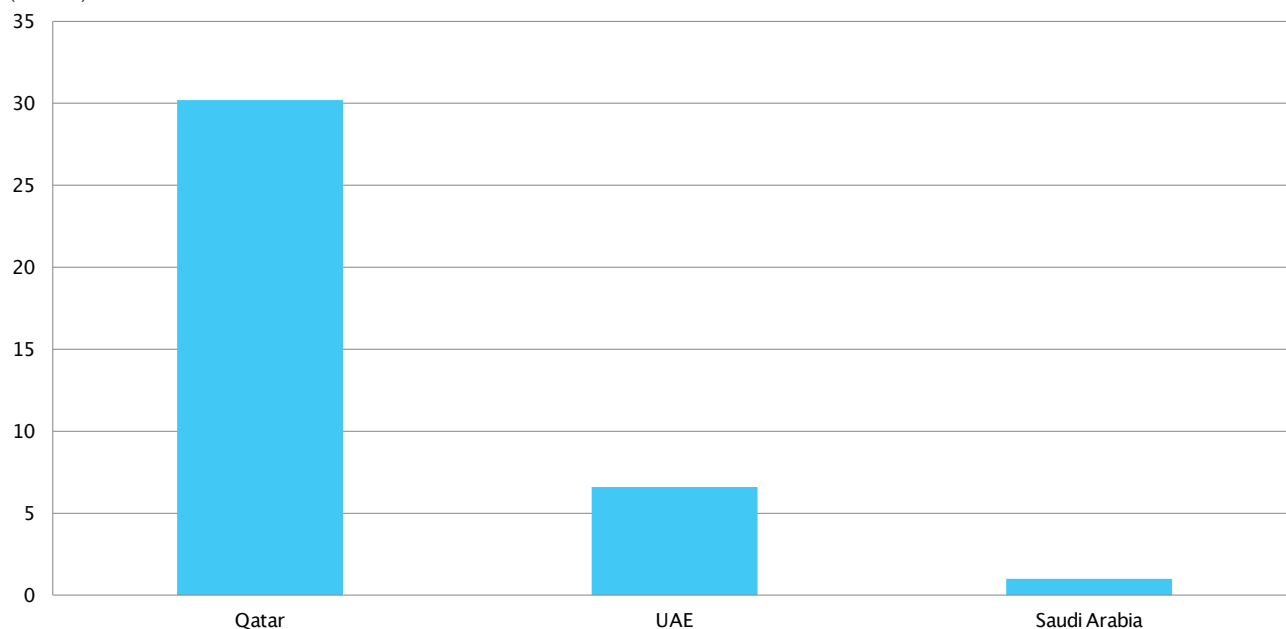
The ability of GCC issuers to tap the Formosa market for sukuk could boost the overall global sukuk market, although it will take time for investor appetite to develop, and issuance is restricted to investment-grade issuers.

The Formosa bond market is nearly entirely U.S. dollar-denominated, making it a good fit for GCC issuers given that GCC currencies are pegged to the dollar. It is also large relative to GCC local sukuk markets, which could benefit sukuk pricing and liquidity if Formosa sukuk grow in popularity. The Formosa bond market had about USD175 billion of outstanding debt at 25 February 2020, compared with total GCC local-currency sukuk of about USD100 billion, and a total global sukuk market of about USD500 billion. The Taiwanese initiative could also boost sukuk's recognition among global investors, which could help to tighten the pricing of sukuk relative to bonds.

The Formosa sukuk market was launched in 2019 after Taiwan's regulators announced guidelines allowing foreign borrowers to issue sukuk denominated in currencies other than the New Taiwan dollar. These instruments can be sold to local insurers, banks and professional investors, as well as internationally. Qatar Islamic Bank was the first institution to enter the market, issuing a USD800 million sukuk in January 2020. This has a five-year maturity, was issued under the bank's senior unsecured trust certificate issuance program (rated 'A' by Fitch) and is listed on the Taipei Stock Exchange.

Formosa Bonds Outstanding - GCC Countries

(USD bn)



Source: Fitch Ratings Bloomberg

Data as at 25 February 2020

GCC issuers, including the government of Qatar, Qatar National Bank, First Abu Dhabi Bank and Arab Petroleum Investments Corporation, have increasingly tapped the Formosa bond market in recent years. This is in line with the trend to diversify funding options, with many GCC issuers issuing kangaroo, samurai and even panda bonds. GCC issuers, led by those in Qatar and the UAE, account for about 20% of total outstanding Formosa bonds.

Qatari banks have been incentivized to look beyond the GCC for funding since the economic boycott of Qatar began in 2017. Qatar's banking sector has the most diversified funding in the GCC, with non-domestic funding representing 43% of total funding at end-2019. Most of this is from depositors in other GCC countries, asset managers in Saudi Arabia and the UAE, and Asian investors.

Demand for Formosa bonds has been driven by Taiwanese life insurance companies seeking higher yields amid low interest rates. Near-term demand should remain high as insurers reinvest proceeds from maturing bonds. About USD15.5 billion in debt held by Taiwanese insurers mature in 1Q20, according to Bloomberg.

However, while overall Formosa bond market growth may continue apace, we expect the development of the Formosa sukuk market to be gradual, despite keen interest from GCC issuers. Several potentially significant sukuk issuers, including Turkey, Bahrain and Oman, are barred from the market as they are below investment-grade. Moreover, it will take time for investors to familiarize themselves with Formosa sukuk, and Taiwanese insurers' ability to invest has been reduced by regulatory moves to limit their foreign-currency exposures.

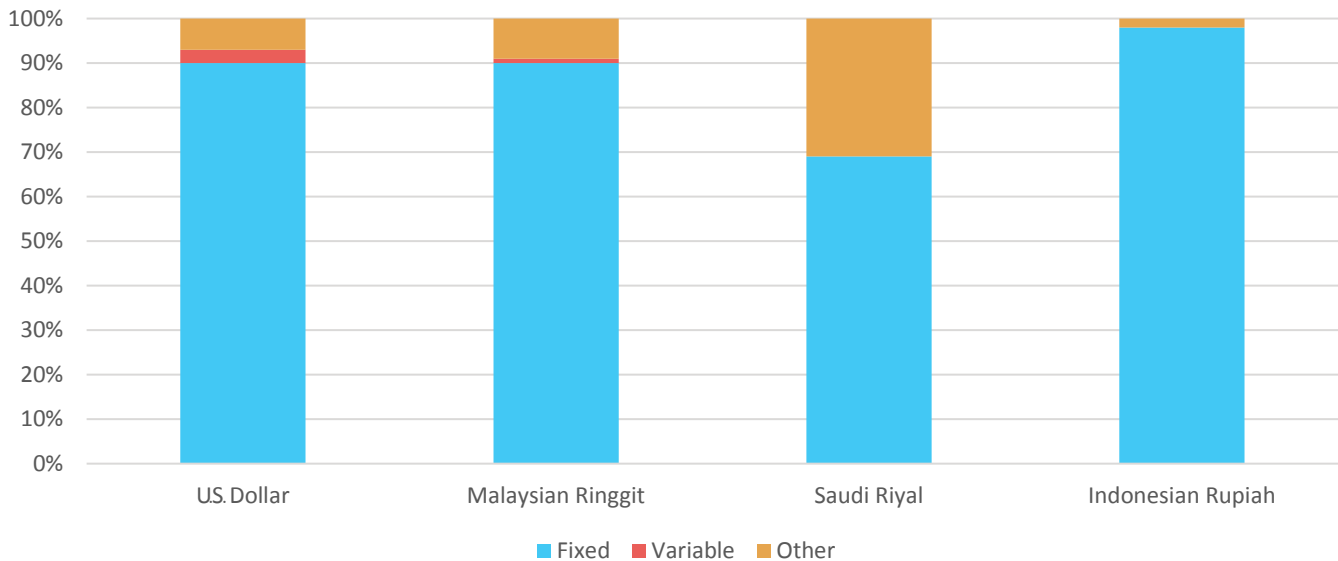
IBOR Transition a Challenge for Small Portion of Sukuk Market

Fitch Ratings-Dubai/London-20 November 2019: The transition to new risk-free rates (RFRs) creates challenges for the small portion of the sukuk market that reference legacy IBORs, Fitch Ratings says. These sukuk will face the same uncertainties as conventional bonds, with the added complexity of how transition to RFRs can be accommodated in underlying sukuk structures.

The bulk of the sukuk market is fixed-rate and therefore is unaffected by the IBOR transitions planned for major currencies by end-2021. Among the major currencies, the planned shift to the Secured Overnight Financing Rate (SOFR) from LIBOR in the U.S. dollar market by end-2021 is the most relevant, as dollar-denominated sukuk constitute just over one quarter of all outstanding sukuk. But of these, over 90% are fixed-rate sukuk.

Outstanding Sukuk by Coupon Type

Dollar, Ringgit, Riyal, and Rupiah-denominated sukuk account for 94% of outstanding issuance



Source: Fitch Ratings Bloomberg

IBOR transition creates challenges for various asset classes. These relate to operational changes, risk modelling and the availability of liquid products for hedging, among other issues. Industry efforts to address them continue, although progress is uneven across jurisdictions and asset classes. Key uncertainties relate to contracts that embed the legacy IBORs, but lack suitable fallback provisions in the event of IBOR discontinuation.

Where possible, we expect the sukuk market to adopt or adapt the initiatives that are taking shape in the conventional bond market. For example, some sukuk now include fallback provisions designed to accommodate a change of reference rate, as seen in conventional bond documentation.

Sukuk face an additional complexity due to the lack of sharia codification. The Accounting and Auditing Organization for Islamic Financial Institutions and many prominent Islamic finance scholars have acknowledged that, under certain conditions, using benchmarks like LIBOR or certain share or commodity price indexes to determine investors' profit margins for Islamic products is possible, notwithstanding the sharia prohibition on riba, or unlawful gains, including interest.

However, even if the new RFRs are deemed consistent with sharia principals, the underlying sukuk structures may need to change. Sukuk are complex instruments, usually based on one or more specific sharia contracts. They typically incorporate an undertaking whereby the obligor commits to repurchase underlying sukuk assets on maturity, covering the outstanding principal and any unpaid periodic distribution amounts, in a timely manner.

There is no standard structure, however, and different underlying contractual arrangements might need to be adapted to the new RFRs deal-by-deal. This process could be time-consuming and require fresh opinions from the originator's and investors' sharia boards that the new structure is sharia-compliant.

Understanding the relationship between the funding arrangement and the asset and the key features of its underlying contractual structure is fundamental to analyzing the credit risk of a sukuk. We would, therefore, monitor any changes to Fitch-rated sukuk as they happen and assess any potential impact on the seniority of the sukuk accordingly.

Our ratings do not imply any confirmation that a sukuk is sharia compliant. Rather, we assess whether non-compliance has credit implications. If any such implications cannot be quantified under our criteria, the sukuk may not be rateable.

Enhanced warranties and waivers clauses aiming to prevent an obligor from challenging sukuk enforceability on sharia grounds are becoming part of sukuk documentation, partly in response to Dana Gas's 2017 attempt to have its sukuk declared unlawful. We believe this trend reduces potential risk from IBOR transition, although Dana Gas subsequent sukuk restructuring left the question of whether sharia compliance has credit implications untested in the local UAE courts.

Islamic Derivatives Increasingly Necessary, but Constraints Remain

Fitch Ratings-Dubai/London-17 June 2020: Recent volatility in key Islamic finance markets caused by the coronavirus pandemic, oil price fall and cuts in central banks repo rates highlights the need to use effective sharia-compliant derivatives as hedging tools (tahawwut). However, derivatives markets remain underdeveloped in most countries where Islamic finance is prevalent. Moreover, issues with the sharia compliance of derivatives and the lack of standardisation and harmonisation across jurisdictions of available hedging instruments are constraining the expansion of Islamic derivatives market.

We consider an increased usage of derivatives for risk-management purposes as positive for Islamic financial institutions, sukuk investors, issuers and sharia-compliant non-financial corporates. Derivatives play a vital role in hedging and mitigating risks that come from volatilities in profit rates, exchange rates and commodity prices. However, the sharia compliance of derivatives is a major limitation. For example, many sharia governing bodies and scholars are of the view that conventional futures and forward contracts are not sharia-compliant. This leaves the halal industry with far fewer hedging instruments compared with their conventional peers.

Furthermore, general guidelines pertaining to Islamic hedging stipulate that transactions should be entered into only for the purpose of hedging actual risks of the relevant party and that transactions should not be entered into for speculative purposes, which means that actual settlement of assets and payments must take place, and that cash settlements cannot take place without finalizing the transaction. This prevents Islamic banks from engaging in speculative activities, but it also prevents Islamic financial institutions from trading derivatives in the same way as conventional banks do.

Islamic banks, similar to conventional banks, face credit risk, liquidity risk, profit-rate risk and currency risks, among others. Conventional banks use derivatives to hedge their exposures against interest-rate risk and currency risk, in addition to offering their customers derivative products. However, more than 30% of Fitch-rated Islamic banks do not use derivatives, and most of the remaining 70% use it in a limited capacity, constraining it to instruments like profit-rate swaps and Islamic-currency forward contracts.

As part of its assessment of Viability Ratings, Fitch analyzes an Islamic bank's exposure to profit-rate risk alongside mitigants employed to neutralize/hedge and manage those risks through, for example, the use of derivatives. Offering sharia-compliant hedging derivative products to their customers would also support Islamic banks' earnings generation capabilities. Hedging is also important for takaful companies as we assess, among other areas, their hedging activities through the lens of risk management and primarily focus on how these institutions reduce their exposures to market risks. We also assess the effects of hedging on insurers' liquidity and solvency. Hedging is also important for sharia-compliant non-financial corporates as we assess their risk management practices.

Another key challenge in analyzing Islamic derivatives is that public disclosures in financial statements are in general limited and do not typically provide detailed information on their intended purpose and their effectiveness. This impedes analysis of the appropriateness and effectiveness of an Islamic bank's hedging programs, as well as their impact on the financial results on a case-by-case basis.

In countries where Islamic finance has a key presence, the derivatives market in general remains underdeveloped. In April 2019, the over-the-counter (OTC) interest-rate derivatives turnover (daily average) in the UAE, Malaysia, Saudi Arabia, Indonesia, Turkey and Bahrain, combined, was only USD3 billion and geographically stood at less than 1% of global

OTC interest-rate derivatives turnover, based on BIS data. Furthermore, with the exception of the UAE, no other Gulf Cooperation Council (GCC) country has an exchange-traded derivatives market, although Saudi Arabia had announced its plan to launch one in 2020.

The future growth of derivatives in key Islamic finance markets will also depend on regulators and policymakers adopting legislations that permit the enforceability of close-out netting provisions and collateral arrangement provisions in derivatives contracts. The enforceability of close-out netting provisions is important as it enables firms to mitigate credit risks by terminating outstanding transactions with a counterparty following an event of default and calculating the net amount due to one party by the other. Collateral arrangement provisions also help to mitigate credit risk by enabling trading parties to pledge variable levels of collateral in support of their trading positions on an ongoing basis.

Close-out netting legislation has not been adopted in certain key Islamic finance jurisdictions like Saudi Arabia, Kuwait, Oman and Pakistan. However, it has been adopted in other key Islamic finance jurisdictions like Malaysia, the UAE (at the federal level and the free zones of Dubai International Financial Centre & Abu Dhabi Global Market (ADGM)), Qatar (Qatar Financial Centre), Bahrain, Turkey and Indonesia. This is a positive credit development, but we will be monitoring how this legislation is enforced in practice for Islamic banks. Legislation pertaining to collateral arrangement provisions has been adopted by Malaysia, Indonesia and Turkey. However, none of the GCC countries adopted this in their legislation, with the exception of ADGM in the UAE.

To address the issue of lack of standardization and harmonization across jurisdictions, various regulatory as well as sharia standard-setting bodies have issued a number of guidelines and standards related to derivatives. One of the regulators active in this segment is Malaysia's Central Bank, Bank Negara Malaysia, which in 2007 issued the Islamic Derivative Master Agreement.

Another initiative was led by the Bahrain-based International Islamic Financial Market (IIFM), which had partnered with the International Swaps and Derivatives Association (ISDA) to publish the ISDA/IIFM Tahawwut Master Agreement. While the uptake of the IIFM's standards is increasing, particularly in Saudi Arabia and the UAE, the market's approach to documentation still remains fragmented and a number of institutions continue to use bespoke documentation, which results in increased negotiations and longer lead time for execution.

"Derivatives usage by small-to-medium sized Islamic banks tend to be limited as they would need to have in place sophisticated risk-management systems and controls due to the increased exposure to counterparty, operational, market, credit and liquidity risks caused by entering into derivatives contracts. Without adequate systems and proper management oversight, the use of derivatives could result in significant financial losses. As Islamic banks evolve their risk-management practices, the effectiveness of their derivatives portfolio needs to be regularly estimated, including its impact on their banks' capital/solvency positions and future profits.

Liquidity Stress Highlights Importance of Effective Sharia-Compliant Repo Market

Fitch Ratings-Dubai/London-08 April 2020: The recent disruptions caused by the coronavirus and the oil price slump are affecting Islamic banks' liquidity and highlight the need to develop deeper sharia-compliant repurchase agreement (repo) markets. We believe a better-functioning Islamic repo market would be credit positive for Islamic banks' funding and liquidity profiles by providing banks with an additional source of short-term funding on a secure and low-risk basis, especially in times of liquidity stress as we currently see.

It can also provide some support to Islamic banks' earnings generation capabilities through a lower cost of funding due to the collateral held. However, issues with sharia-compliance, the lack of standardization and regulatory hurdles are hindering the growth of the Islamic repo market and its acceptance among counterparties.

The economic downturn caused by the coronavirus pandemic and the sharp fall in oil prices are reducing banks' liquidity in Islamic finance's core markets, namely Gulf Cooperation Council (GCC) countries and Malaysia. While each of these countries is at a different stage of development, Malaysia's money and repo markets are the deepest and most liquid. The country has well-developed domestic debt capital markets that drive a broad range of collateral eligible for repos under sale and buy back agreements (SBBA) with the central bank ranging from sovereign sukuk to Islamic private debt securities. Funding options for Islamic banks in Malaysia are broader than in other countries due to the longer repo tenors available.

In the GCC, the Central Bank of Bahrain is leading the way by introducing sharia-compliant liquidity management tools, such as the Islamic Sukuk Liquidity Instrument (ISLI) and the Wakalah, an intraday credit (IDC) facility available to Islamic banks against their tradable Islamic securities holdings (Sukuk-al-ijara). The latter is designed to ensure a level playing field between Islamic and conventional banks, and increase the efficiency of the monetary policy. However, banks' recourse to repo funding in the past has been limited as high oil prices have supported banks' liquidity through strong deposit inflows from government and government-related entities, which represent about a third of total deposits on average.

However, during the previous oil price shock in 2015-2016, we saw Gulf central banks injecting liquidity into the banking system through repo facilities with commercial banks which had suffered from tightening liquidity, thereby providing banks with contingent liquidity sources. This was accompanied by tenor extension of repo operations, particularly in Saudi Arabia and Qatar, and broadening the range of collateral eligible for repo operations in the UAE. With the economic boycott of Qatar, the Qatar Central Bank's (QCB) repo operations skyrocketed to QAR413.9 billion in 2017 from QAR3.4 billion in 2016 to alleviate banks' liquidity pressures.

Should the economic disruptions caused by the coronavirus continue and oil prices remain low, we expect central banks across the GCC to increase repo facilities and provide additional sources of liquidity to banks. Most GCC countries have already announced that additional liquidity will be made available to support the banks if needed and this includes banks' access to repo funding at their respective central banks.

Compared to their conventional peers, Islamic banks face several constraints to raise funding through repo markets, especially for bank-to-bank transactions. These constraints include differences in sharia interpretation, lack of standardization and regulatory hurdles faced by Islamic banks. Malaysia's Islamic repo structure, SBBA, is not viewed as sharia-compliant in GCC countries, where Murabaha, Ijara and Tawaruqq are mainly used. This lack of harmonization hinders growth.

To address the issue of standardization and provide an alternative to conventional repo, the Bahrain-based International Islamic Financial Market published the Master Collateralized Murabaha Agreement in 2014. While we view the creation of the standard as a positive step, its uptake has been low, with implementation mostly limited to the UAE. To support short-term liquidity management at Islamic banks and liquidity in secondary markets, the International Islamic Liquidity Management Corporation, based in Malaysia and owned by various central banks, has issued about USD53 billion of short-term and tradable sukuk denominated in U.S. dollars since 2013. However, we believe this amount would need to be inflated to create a functioning and liquid Islamic repo market.

Regulatory hurdles are another challenge. Some countries with less-developed Islamic finance ecosystems, such as Oman, Jordan and Morocco, do not have any Islamic repo facilities with central banks or have a very limited offering. This places Islamic banks at a disadvantage to their conventional peers, which is especially problematic given the current tight liquidity conditions. However, some other jurisdictions are being proactive in developing sharia-compliant liquidity management tools. In 2018, Turkey launched the Committed Transactions Market of Sukuk, which enables bank-to-bank repo transactions, while banks can have access to repo funding through the central bank through sovereign sukuk and lease certificates as collateral, albeit with shorter tenors than conventional banks. In the UAE, the adoption of the Accounting and Auditing Organization for Islamic Financial Institutions standards has been compulsory for Islamic banks since September 2018; its impact on the Islamic repo market is evolving and is still being assessed.

GCC Islamic banks' funding profiles continue to benefit from strong retail networks, a high share of low-cost customer deposits and low reliance on wholesale funding, all of which support the stability of their funding base. Their liquidity is supported by a good proportion of liquid assets (in the form of cash balances with central banks and held-to-maturity domestic sovereign sukuk) relative to their customer deposit base. Nevertheless, Islamic banks' Viability Ratings factor in their lower ability to access contingent liquidity through sharia-compliant repo funding.

Research, Commentary and Publications

The Islamic Finance Group publishes a wide range of specialized research and commentary across sectors and regions on major developments, industry outlooks, and market trends, including Rating Action Commentaries (RACs), Fitch Wires, and special reports.

Recent examples include:

- [GCC Bank Credit Profiles to Weaken Despite Unprecedented Stimulus](#)
- [Islamic Mutual Fund Asset Differences Emerge from Pandemic](#)
- [MMFs Central to AUM Divergence in Major Islamic Fund Domiciles](#)
- [Saudi Islamic Banks' Financial Metrics Deteriorated, but Sound](#)
- [Saudi Islamic Banks: 2019 Dashboard](#)
- [New Philippine Regulations May Boost Islamic Banking](#)
- [Malaysian Islamic Banks' Growing Contribution to Continue](#)
- [Malaysia Islamic Banks Dashboard 2020](#)
- [Indonesian Islamic Banking Roadmap to Boost Sector Development](#)
- [Indonesian Islamic Banks Dashboard: 2020](#)
- [UAE Islamic Banks Not Isolated from Low Oil Prices, Coronavirus](#)
- [UAE Islamic Banks: 2019 Results Dashboard](#)
- [Turkish Islamic Banks Have Small Market Share; Reasonable Medium-Term Prospects](#)
- [Turkish Islamic Banks Dashboard](#)
- [Asset Ratio Requirement Credit-Negative for Turkish Banks](#)
- [Qatari Islamic Banks' Asset Quality Weakening; Still Better than Conventional Banks](#)
- [Qatari Islamic Banks: 2019 Results Dashboard](#)
- [Indonesia's Takaful Sector Backed by Economic Developments](#)
- [Indonesia Takaful Dashboard: 2020](#)
- [Global Sukuk Market Dashboard](#)
- [Malaysia Takaful Dashboard: 2020](#)

Fitch Named Best Islamic Finance Rating Agency for Fourth Year

Fitch Ratings has been recognized as the Best Rating Agency for Islamic Finance for the fourth consecutive year by The Asset, a leading financial magazine in the Asia-Pacific region. The agency was also recognized as the Best Islamic Finance Rating Agency by the Global Islamic Finance Awards (GIFA) 2020.

Established in 1999 in Hong Kong, The Asset is a multi-media company whose publications, events and awards are widely followed by market participants in the Asia-Pacific region. The awards are adjudicated by the publication's Board of Editors and Benchmark Research team, who also obtained feedback and testimonials from issuers, investors and other market participants in Asia and the Middle-East as part of the evaluation process.

Established in 2011, the objective of GIFA is to highlight the best practices in Islamic banking and finance. Winners are decided by a nomination committee based on proprietary methodology undertaken by Cambridge International Financial Advisory. Selection criteria for the awards include innovation, quantity and quality, cross-border reach of products and services, as well as social responsibility, sharia authenticity, and commitment to Islamic banking and finance

Fitch rates more Islamic banks than any other global credit rating agency, covering more than 35 Islamic finance-based issuers worldwide and more than 140 outstanding Islamic finance instruments. It has the largest market share of rupiah sukuk issuance in Indonesia. Fitch has dedicated sukuk rating criteria and provides takaful-specific considerations within its global insurance rating criteria. It also provides specific consideration to environmental, social and governance factors in its ESG scores in rating Islamic banks and was the leading agency to provide globally standardized cross-sector rating action commentaries.

Recent landmark deals in which Fitch participated include the first sovereign green sukuk, issued by Indonesia in 2018, and its followup issues in 2019 and 2020, as well as the first benchmark U.S. dollar corporate green sukuk issued by Majid Al Futtaim in 2019. Fitch also rated the first Formosa sukuk issued by Qatar Islamic Bank in January 2020 that was listed on the Taipei Stock Exchange. The agency also rated DP World's hybrid sukuk in 2020, which is the first corporate hybrid sukuk to have an international rating. In addition, Fitch rated Islamic Development Bank's first sustainability sukuk, which aims to help member countries tackle the aftermath of the COVID-19 pandemic.



Best Islamic Finance Ratings Agency 2017-2020 at The Asset Triple A Finance Awards



Best Islamic Finance Ratings Agency at the Global Islamic Finance Awards 2020

About Fitch's Islamic Finance Rating Team

The agency's Global Head of Islamic Finance, Bashar Al Natoor, and the Islamic Finance Group coordinate all Islamic finance activities and expertise across the Sovereign, Financial Institutions, Corporates, Structured Finance, Infrastructure, and Insurance teams worldwide.



Bashar Al Natoor

Global Head of Islamic Finance

Bashar Al Natoor is responsible for coordinating all Islamic Finance activities across Fitch's Sovereign, Financial Institutions, Corporate, Structured Finance, Infrastructure and Insurance teams, bringing together dedicated analytical and industry expertise into a centralized and focused Islamic finance group.

Al Natoor has more than 20 years of experience in the Islamic Finance market. Since joining Fitch in 2007, he has overseen Fitch's sukuk criteria and Islamic Finance practices, undertaken research and written numerous published articles on Islamic Finance. Al Natoor joined Fitch as a director in the EMEA Corporates group based in Dubai. He was responsible for analyzing EMEA issuers, with focus on Middle Eastern and Turkish issuers in the Construction, Property and Telecommunications sectors. Prior to joining Fitch, Al Natoor spent seven years at the Islamic Development Bank (IDB) in key roles, including Investment Officer in the Treasury Department, a Senior Credit Analyst in Risk Management and Senior Technical Assistant to the Vice President of Finance & Administration. Before working with IDB, Al Natoor was a senior auditor for four years at Arthur Andersen.

Al Natoor graduated with an MSc in Banking and Financial Studies from the Arab Academy for Finance and Banking Science and a BS in Finance and Banking from Amman University. Bashar is also a Certified Bank Auditor (CBA), a Certified Risk Professional (CRP), a Chartered Market Analyst (FAD-CMA), and a Certified Risk Analyst (CRA).



Saif Shawqi, CFA

Senior Analyst - Islamic Finance

Based in Dubai, Saif monitors the credit developments affecting the Islamic finance industry and supports the Islamic finance group on research pieces across a range of industry-relevant topics. His role also involves rating new as well as existing Islamic finance entities and sukuk transactions.

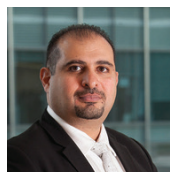
Prior to joining Fitch, Saif worked at Al Baraka Banking Group as the Head of Section - Credit & Risk Management, where he covered Financial Institutions (FI) & Sovereigns in the Middle East and Africa (MEA) region. Saif is a CFA charter holder and has a Bachelor's degree in Banking & Finance from the University of Bahrain. He holds the CIMA Diploma in Islamic Finance.

For more news and analysis, please visit Fitch's dedicated Islamic Finance website at:

<https://www.fitchratings.com/site/islamicfinance>

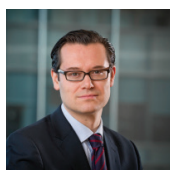
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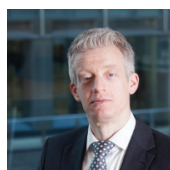
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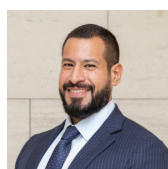
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