January 17 2011

Issued on behalf of Trowers & Hamlins LLP

Gulf sukuk issuance bounces back 61% following recessionary crisis

- **Gulf conventional bond issuance surges to record high of $15bn**
- **Sukuk issuance reaches $7bn**

The value of Islamic 'bonds' (sukuk)[1][1] issued in the Gulf[2][2] has jumped 61% in the past year having slumped to the lowest level in four years as a result of a number of factors, including the global financial crisis, according to research by Trowers & Hamlins, the international law firm. $7bn of sukuk was issued in the Gulf in 2009/10 (to June 30), compared to $4.3bn the previous year.

At the same time issuance of conventional bonds surged to record levels. The value of conventional bonds issued in the Gulf hit $15bn in 2009/10 compared to $12.9bn the year before, an increase of 16.3%.

Trowers & Hamlins says that the sukuk market was hit much harder by the credit crunch and global financial crisis than the conventional bond market in the Gulf.

In addition to the wider negative effect on global financial markets flowing from the credit crisis, the reputation of Sukuk and sentiment to sukuk as potentially safer investment instrument than vanilla corporate bonds took a battering after investors were left nursing potentially heavy losses following several high profile sukuk defaults (e.g. Golden Belt, Investment Dar and International Investment Group). These defaults hit demand for sukuk as investors realised that, contrary to popular (but often misplaced) belief, many sukuk were neither genuinely asset-backed nor came with an express or implicit sovereign guarantee.

Trowers & Hamlins says that, as well as facing these broader structural issues, many sukuk were primarily based on land values and/or revenues intended to flow from real estate and construction projects, an asset class and sector that lost much of its allure during the downturn, with Dubai particularly hard hit. Issuers are now looking for other asset classes which may form a suitable basis for sukuk and also reverting to "debt" (e.g. ijara) rather than equity based structures, such as musharaka.

---

[1][1] Sukuk are transferable Islamic ownership or trust certificates that are often compared to conventional bonds or certain asset-backed securities and are structured in a way that complies with Islamic law, which forbids the payment and receipt of interest

[2][2] Members of the Gulf Cooperation Council (GCC) are Saudi Arabia, Kuwait, Bahrain, Qatar, the United Arab Emirates and the Sultanate of Oman

Neale Downes, Regional Banking & Finance Partner in the Trowers & Hamlins' Bahrain office, comments: "While sukuk issuance has rebounded, it is still less than half of its peak in 2007/08. The financial crisis was the first real test for sukuk. Investors are flocking to the comparative safety of conventional bonds while issuers address some of the particular legal and structural concerns surrounding sukuk and their robustness in a default or insolvency scenario."

"The crisis laid bare several misunderstandings about sukuk. Many investors assumed that sukuk came with a sovereign guarantee, or that if the issuer defaulted they would have an underlying asset as 'security' or that they (or their trustee) had sole recourse to such asset. The limitations of merely asset-based sukuk are now more widely understood."

"With restricted access to liquidity from banks, borrowers have been forced to access other sources of debt or capital. But with the cost of issuing sukuk now about 60% more expensive than bonds, corporates have largely turned to conventional debt."

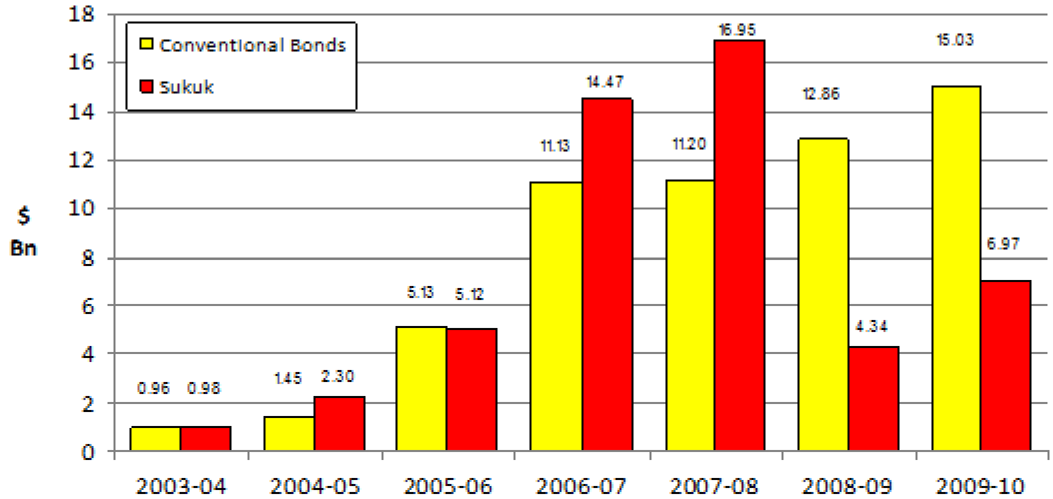
He adds: "The market reached its nadir in 2009 but sentiment towards sukuk now appears to be recovering strongly. There is every reason to believe that demand for sukuk will eclipse its pre-credit crunch peak in the coming years."

According to the research by Trowers & Hamlins, however, the majority of sukuk issued over the past year were issued by banks and by sovereign or quasi-sovereign entities. Banks have been looking to raise fresh capital to repair or bolster their balance sheets. Many are expected to issue sukuk to meet the increased capital requirements of Basel III.

According to Trowers & Hamlins, a combination of commercial or market-related factors led to steep falls in the price of sukuk:

- During times of financial stress investors tend to avoid newer, complex and less tested forms of investment in favour of more traditional investments – a trend from which sukuk are more likely to suffer from than conventional bonds

Issuance of corporate sukuk and conventional bonds in the Gulf (US $bn)



Broader legal problems

Neale Downes says that the reputation of sukuk was hit by several high profile defaults. Investors had assumed that they would have security over or sole or first call on the assets on which the sukuk were based, but this confidence proved misplaced.

Explains Neale Downes: "The idea of taking possession of tangible assets on default, often real estate, made sukuk very attractive to investors. The reality has turned out very different, with sukuk investors having to form an orderly queue with other unsecured creditors of the originator."

"Subscribers to sukuk are meant to be part owners of assets so in theory, their credit and risk profiling should be based purely on an assessment of the value of and revenue generating potential of those assets, instead of just the paying ability and balance sheet of the company issuing the sukuk. In the absence of such a treatment and the ability properly to segregate those assets for the certificateholders, sukuk become little or no different from conventional corporate bonds."

The defaults have highlighted the disparities between English/Common law, by which nearly all sukuk documentation has been governed and civil law systems that prevail in most of the Gulf States calling into doubt the validity of:

- the transfers of assets from the balance sheet of originators to issuer SPVs and
- the trust arrangements upon which issuers hold assets for the benefit of their investors

The further interaction between English law, local laws and the Shari'ah (not law per se but a set of principles and teachings) adds a further level of complexity both when putting deals together and when later seeking to unwind or restructure such arrangements.

ENDS

Notes to editors:

Trowers & Hamlins is an international and City law firm with 121 partners and over 700 staff. The firm has three offices across the UK and five offices in the Middle East (Abu Dhabi, Bahrain, Dubai, Cairo and Oman) as well as a co-operation agreement with two offices in Saudi Arabia and associations with firms in Syria and Jordan.

Trowers & Hamlins has been voted "Legal Firm of the Year" in this year's FDs' Excellence Awards. The award, supported by the CBI and by Real Business Magazine, is based on the results of a survey of 1,000 Finance Directors across the UK. Finance Directors polled commended Trowers & Hamlins for their "high quality" and "supportive" service.

Trowers & Hamlins received the award for outstanding contribution by a law firm to Islamic Financial Services at the 2010 Annual Sukuk Summit Awards. The Sukuk Summit Awards recognise excellence in the Islamic finance sector and are judged by industry experts from across the GCC, Europe and South East Asia.

Trowers & Hamlins is a limited liability partnership.

Press contacts:

Neale Downes
Partner
Trowers & Hamlins
Tel: +973 17 515602 (Bahrain)

Paul Arvanitopoulos or Nick Mattison
Mattison Public Relations
Tel: +44 20 7645 3636 (London)