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Dubai Islamic Economic Roundtable

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IFN Roundtable 2015: Sukuk and the Islamic Capital Markets

Panelists

Basheer Ahmad
Senior Manager-Markets, DFSA

Mohieddine Kronfol
Chief Investment Officer, Franklin Templeton Investments

King & Spalding

Nabil Issa
Partner, King & Spalding Middle East

Rizwan Kanji
Partner, King & Spalding Middle East

Moody's

Khalid F Howlader
Global Head of Islamic Finance, Moody's Investor Services

Ahsan Ali
Managing Director, Head of Islamic Origination, Standard Chartered Saadiq

Moderator

Lauren McAughtry,
Group Managing Editor, IFN/REDmoney Group

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Jehad El-Nakla
General Manager
Dubai Int'l Financial Centre
jehad.el-nakla@moodys.com
+971.4.237.9535

Khalid Howladar
Global Head, Islamic Finance
Dubai Int'l Financial Centre
khalid.howladar@moodys.com
+971.4.237.9542

James Flitton
Vice President
Business Development
james.flitton@moodys.com
+65.6398.8338

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Basheer Ahmed
Senior Manager, Markets, DFSA

Mohieddine Kronfol
Chief Investment Officer, Franklin Templeton Investments

Ahsan Ali is responsible for the global Islamic origination business at Standard Chartered Saadiq, and has led all its Islamic project and structured finance, corporate finance and advisory, syndications and capital market transactions across multiple geographies and products, including several landmark and industry-first deals. He joined Standard Chartered in 2004 from Citigroup and has over 20 years' experience in the financial services industry, of which the last 12 years have been in Islamic banking.

Nabil Issa is a partner in the Middle East and Islamic Finance Group of King & Spalding, working from the Dubai and affiliated Riyadh offices. Prior to joining King & Spalding, he worked for leading law firms in Dubai and Riyadh and was also an adjunct professor of business law at the University of Sharjah's College of Business and Management. His experience includes work in the areas of banking and finance, Shariah-compliant funds, private equity, international investments, healthcare and energy industry transactions, and Islamic finance issues. He is particularly known for his development of innovative Shariah-compliant CMA funds and investment structures for real estate and private equity investments in Saudi Arabia and the UAE.

Rizwan Kanji is a partner with King & Spalding specializing in debt capital markets and securitizations both conventional and Islamic including Islamic finance structures. He has been active in the Middle East for over seven years and frequently advises a variety of global investment banks, sovereign states and multinational regional corporates.

Khalid Howladar is the global head of Moody's Islamic Finance Group and also leads the GCC Banking team in Dubai. Currently based in the Dubai International Financial Center (DIFC), he joined Moody's in the UK in 2001 and was initially an analyst responsible for rating cash, synthetic, high yield, structured and project finance CDOs before taking a lead role in the MENA Business Development team with responsibility for new markets and client outreach and subsequently taking leadership of the Dubai-based banking team in 2010. Previously, Khalid spent four years with Credit Suisse in the emerging market fixed income group in the Risk Management team.

Basheer Ahmad is a Senior Manager in the Markets Division at the Dubai Financial Services Authority (DFSA) and joined the Division in May 2008. He is part of the team responsible for the regulation of primary market operations with specific emphasis on managing wholesale securities transaction approvals. His particular expertise is in the review of Sukuk and other Islamic finance products and is a member of the Islamic Finance expert group of the DFSA.

Mr Ahmad has over 17 years of experience in financial services regulation. Prior to joining the DFSA, he worked at the Securities Commission of Malaysia where he gained significant experience for developing and implementing primary market policy and regulation. Other professional experience in Islamic and other financial services include being a trustee in the Labuan offshore financial market in Malaysia and as a deputy prosecutor with the International Advisory Division of the Attorney General's Chambers of Malaysia.

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Mohieddine (Dino) Kronfol is a chief investment officer of Global Sukuk and MENA fixed income at Franklin Templeton Investments. Mr. Kronfol is responsible for the investment process, research and performance of the Global Sukuk and MENA Fixed Income teams. He is one of the founding partners and board member of Franklin Templeton Investments (ME), formerly Algebra Capital, and has been with the firm since its inception in 2006. He is the lead portfolio manager of the FTSF Global Sukuk Fund and FTIF GCC Bond Fund and a member of the Franklin Local Asset Management Team.

He was previously the head of SHUAA Capital's Debt Asset Management where he launched and managed the first fund to focus exclusively on MENA debt.

Sukuk and the Islamic capital markets

Backed by rising liquidity and sound financials, Dubai as become a hotbed for investors – domestic and international – looking to take advantage of the region's growing economy and increasing curiosity among local issuers and investors on the prospects of Shariah compliant finance. How has or will Dubai attract issuers (both domestic and international) to use Dubai as the issuing center?

In April 2015 a group of industry-leading regional and international experts gathered together at the DIFC in Dubai to conduct a high-level discussion on current and future of Sukuk and the Islamic capital market With a broad range of perspectives including from the regulatory, practitioner, legal and investor angles, the debate sought to uncover the key trends and developments in the local, regional and global Sukuk market both currently and going forward: identifying the major challenges and opportunities for the industry to develop and discussing how Dubai could support that growth in its bid to become a central hub for the Islamic economy.

Islamic Finance *news* was delighted to bring together the comprehensive knowledge and experience of leading industry experts to achieve a rewarding and challenging panel debate.

Moderator: We are going to spend about 90 minutes discussing Sukuk and the Islamic capital markets, with an excellent panel of speakers who have come in from all sides of the market. Just to give you a quick outline of the agenda and the way this will go: there are multiple sections to the framework of today's roundtable. So first we will discuss the current landscape, the role of Dubai, its regional positioning, developments in Sukuk structure and innovation, and then a quick look at the outlook over the next few years. If any of our audience members would like to ask questions or query a particular panelist, then although we are fairly limited in time I will open the floor to questions at the end of each segment.


Ahsan

So let's kick off with a look at how the current global environment for the Islamic debt capital markets are going, and how this year is looking – perhaps compared to 2014, which was of course a very good year for Sukuk. Let's start with Ahsan, what are your views on the current landscape?

Ahsan: In terms of 2015, the first three months or so I would say have been quite good. In terms of the new issuances we have seen quite a few come into the market. It started off with the Dubai Islamic Bank (DIB) Tier 1 capital deal and then this week we saw Emirates Airline doing the first ECA-backed debut Sukuk. We had PETRONAS issuing Sukuk and a conventional bond; and as for other market news we know there are other sovereigns and corporates lined up to come to the market in the next few months. I wouldn't hazard a guess as to whether 2015 will surpass 2014, but I think that it has been a pretty good year so far.

Khalid: I would just highlight a couple of factors that I think may drive volumes. One of the things is the expectation of a low oil price, so what you are seeing with some of the banks is reduced liquidity. The last few years we have been in an era of very cheap funding and excess liquidity, and as this starts to tighten this may push the banks to hold back a bit, and so the corporates in turn will need to go out and raise funding in the market. The only other issue is that the natural buyers of Sukuk in the Gulf are actually mostly banks – unfortunately there aren't many pension funds, there aren't many mutual funds – you have few real money investors who in other markets would be buyers of bonds. So if the banks are also facing reduced liquidity then not only are they not funding corporates, who then have to go to the Sukuk market; but the local buyers of Sukuk are the banks themselves so it creates a tension on both sides. But with European yields being very low, with spreads being very low, negative yields, etc – the appeal of Gulf paper including Sukuk may attract more European investors. So I think there are some positives and some negatives; but to be honest my view is generally flat for this year, with perhaps a slightly positive slant.

Mohieddine: Our basic view is that we should have a continuation of the recent past, and that the market should continue to outperform other fixed income sectors in the sense that we continue to get compelling returns with relatively low duration, lower risk, low correlation to other fixed income sectors. I think those attributes are likely to persist. There have obviously been some significant changes – the

lower oil price not only affects the exporters here but it is affecting inflation expectations, monetary policy, etc. It's also impacting other emerging markets and that's having an impact on the currencies of those countries, so we are seeing more volatility in that area. Obviously geopolitics is now a bigger consideration, and that's going to impact the amount of continued penetration of European and US investors into these markets to a certain degree.

Having said that, just because it is going to be a bit more challenging or there is a little more uncertainty, I don't think the prospects are any less bright. We still feel that the market will continue to grow, and will continue to be characterized by a lot of innovation as well.

Moderator: So we are getting some positive forecasts – if we can just drill down a little, what about the type of issuances we are seeing? Last year for example we saw a lot of sovereign deals come to market, will we see that trend continue or will there be an increase in corporate involvement as well? Perhaps we can turn to the lawyers for their view on this.

Rizwan: I think two things, just to add to what my fellow panelists are saying. The growth in 2015 will also be stimulated in some jurisdictions by the implementation of Basel III which will require some capital adequacy calculations by a number of Islamic financial institutions, which will trigger capital raising issuances – and I think that will definitely stimulate the growth or at least the continuation of the growth story from 2014. One thing that I think we are definitely seeing as practitioners is the public high value large ticket size issuances. We are also seeing a pretty solid bulge from the middle market – the SMEs who are undertaking private placement issuances on a short-term basis, on three or five-year paper. Very much so in the UAE and definitely in


Nabil

Saudi Arabia as well. So I think we are looking at that market as a pretty active market. Those calculations, those private placements must be placed into the core of calculating Sukuk. In fact, I would already put my hand out and say on those terms, 2015 will be a better year than 2014 certainly for private placements.

From an innovation perspective, I think it is fair to say that there is certainly more of this middle market, unrated private placement type Sukuk. Call it a club Sukuk, call it whatever you want, but I think there is a growth phase in that market.


Rizwan

Moderator: That gives us a good introduction and overview to the Sukuk market, let's move onto Dubai's role specifically in that. This is a roundtable focusing on Dubai as a center for the Islamic economy so of course one of the things we want to look at is how the initiatives it is taking are assisting in its ambition to become a global Sukuk hub. How it has positioned itself and how successful it has been so far. Basheer, I know with the DFSA you have been very involved with this – perhaps you could walk us through what you are seeing?

Basheer: There may be direct correlation between the Dubai Islamic Economy Initiatives and the activities in the Sukuk market because what we notice is that there is certainly an increased interest in the listings since the launch of those initiatives. We are also seeing interest in different types of Sukuk issuances (asset-backed) and issuers from Asia coming to list in the DIFC. While the DFSA does not play a role in terms of marketing the Center, we have seen other stakeholders in the DIFC who have since become quite instrumental in promoting Dubai as a global hub for Sukuk. For example, NASDAQ Dubai recently introduced the fixed income trading platform to facilitate on-exchange trading just in case if some Sukuk Issuers are interested to trade in the open market space, although we have yet to see any activity on that platform. In addition, we find that NASDAQ Dubai is working with Emirates Islamic Bank and Emirates Islamic Financial Brokerage to provide clearing and settlement services for Sukuk Murabahah platform that is now being used as an alternative platform to facilitate financing activities by the banks. As I understand, a local bank was reported to have joined that Murabahah platform.

Moderator: You say that up till now there has not been much interest in the fixed income trading platform – why is that, can any of our panelists shed some light on this? Why are people not using it?

Ahsan: I think today, how the Sukuk market operates is as an institutional market. It is primarily between the institutional investors – there are no retail Sukuk here. There have been in other countries, like Malaysia and Pakistan, but not really here in the GCC. So most of the Sukuk listed today on NASDAQ are all bought by institutional investors – primarily banks and then asset managers and funds. The trading today on Eurobonds, Sukuk, whatever format, is primarily-over-the counter (OTC) trading between the institutional players, and they do that directly through the clearing services. So this is why clearing on the exchange does not really happen today – and not just for Sukuk but for conventional bonds as well, it is exactly the same. These are primarily driven by institutional buyers; so trading is still largely restricted to OTC.

Rizwan: Just one question – do you think that it is also a question of lack of supply, that investors are mainly holding to maturity rather than trading?

Ahsan: We have seen Sukuk trading pick up – we are one of the largest market makers today in Sukuk and in Middle Eastern securities out of our DIFC office. Trading is much better than it was five or even three years ago – there is a lot more trading in Sukuk happening, but because it is OTC trading between buyers you just don't see it show up on the exchange. That is the primary reason. Trading has picked up – of course it still lags behind trading in conventional bonds, say in the European or the US bond market. But trading in Islamic instruments has picked up definitely.

Mohieddine: I would just like to highlight that the challenges to trading are not based on the Sukuk format. These are developing markets, but the Sukuk trade pretty much in line with the way conventional bonds trade here. So I would say that Sukuk are much more mainstream, investors today are quite comfortable with both, and so instead we need to be addressing market depth. The long-term challenges to liquidity is where we need to see some of the structural reforms take place. That means, on the demand side for example, facilitating the creation of domestic asset pools. Also having the legislation put in place for pension funds, improving the fund regime so that we can gather assets together and become larger players,and work on insurance companies participating. Unfortunately, I do not think we have made enough progress there.

And on the supply side, I think you make a very fair point. Maybe now, with lower oil prices, the prospect of budget

deficits in the region and so on – I am hoping that they maybe use this as an opportunity to kick start the development of a more active domestic money, bond and Sukuk market. But I think those are the areas where we haven't seen as much progress. So in spite of all these visions and ambitions about promoting the region as a global hub for Sukuk, I think unfortunately we have made slow progress on that front, and I hope to see more legislation going forward.

Moderator: So what do we need to see?

Nabil: I'd like to take a minute to talk about the major role we are seeing DIFC play in making Dubai a hub. One of the challenges over the years – as someone who has been working in the region for 16 years – is when you want to structure any sort of product in the region – let's say in Kuwait or Saudi Arabia, for example, two of the more challenging markets. To the extent that anyone says they want to do an asset-backed product, they immediately receive the answer (to be frank with you): "Well that's a bad idea" – for all sorts of local regulatory reasons. A local LLC can't issue a Sukuk. Other companies can take six to nine months to issue a Sukuk. If we're going to have a Cayman entity issue the Sukuk it's going to act as a foreign investor and therefore can't be involved in a Sukuk Ijarah because it can't ultimately own the property involved. So then you get into asset-based structures instead. But for the first time, thanks to the DIFC and the fact that it has English law courts, English law-trained judges, etc, and the fact that the DIFC – and I don't think this is very well known in the community, but the DIFC is recognized as legal in the GCC as far as all the GCC jurisdictions are concerned. So suddenly, if you structure it carefully enough, you can have for example an LLC in Saudi Arabia, holding a piece of land owned by two DIFC special purpose companies that are GCC-owned, controlled by a Cayman entity through a Mudarabah structure, and then you can have a Sukuk Ijarah at the lower level. Rizwan and I have been working on various clients on these sort of structures. Thanks to these innovations, and the DIFC saying well we don't need to have the same laws that were copied from Egypt, that were taken to Kuwait, taken to the UAE, spread around the Gulf – instead of that we can take advantage


Khalid

of English law principles, common law principles, English law courts, precedents and so forth, and have a robust securities structure that I think the rating agencies are very comfortable with – they can actually rate them because they can see a strong, understandable structure that translates internationally. So I think in recent times the lawyers and issuers are starting to understand the power of using the DIFC for this.

Khalid: A couple of comments on that. Indeed, way back before securitization became a dirty word, we did actually see asset-backed structures and we were in fact able to rate them. When transactions were proposed to us from Saudi Arabia, or other jurisdictions, we looked very carefully at the legal opinions, and there were usually some issues there or some problems. From our standpoint, we are operating to a global standard and we actually can't get to the same level of comfort that in a default or an insolvency, the investors would have the same rights as they would in a Spanish transaction or a US transaction. So I guess I would ask a question back to you – we saw some of this five or six years ago with Sun Finance in Abu Dhabi, with Tamweel, etc. You seem to be implying that you do actually have customers who want to do asset-backed transactions, now that the legal impediments are being removed - but the natural buyers of asset-backed transactions are in Europe. Is that something you see as a trend happening now? Because the dominant trend in the Islamic capital market has always been for unsecured transactions.

Nabil: Well that's exactly right, and that's why we have been using this for securitization structures, like you said. And now, let's say you have a party in Europe, to get them more comfortable – let's say when they looked at Saudi law risk, they said no thank you – no law firm that can honestly stand behind a legal opinion is going to give you a clean Saudi law opinion on being able to enforce your securities there. But the beauty of this structure is that you get it at a high level. You have, let's say, a Saudi Arabian LLC holding an asset. You've now moved the asset into an SPV, in a sense.

Khalid: But do you have customers that want to do that? Because in my experience, the issuers don't actually want to give up.

Nabil: No, and you make a good point. But we are now having these discussions again for the first time. There are two securitizations that we are working on at the moment in Saudi Arabia. So we do see some interest. But I think that the belief is that you can't get a proper secured structure, you can't get a clean opinion, this is impossible so let's not waste time and money going down that road. So with forums like this, it is important to highlight to potential issuers that there is a way – that you can have your Saudi LLC, owned by two DIFC SPVs, governed by English law, with a full robust English law security package – a pledge over those shares, English law power of attorney, etc. Then suddenly you find people saying – this looks interesting, it looks like the sort of security package that we could construct in the UK, or New York, and now you are telling me we can bring that down to Kuwait or Saudi Arabia – this is interesting. I'm not saying that people are lining up outside the door to do it immediately, but they are saying: we have not heard anyone tell us this in a number of years, and we want to know more.

Khalid: So one last point on that – because one of the things that we see in the region is that a lot of corporates here are unrated, and they are not comfortable with disclosure of growth, etc. But with securitization, if you have good assets – like Tamweel for example – they were unrated at the time but they had good assets so they were able to go out to the market and get financing despite the fact that they were unrated. And that was on par with a sovereign.

Rizwan: And in your words, from Moody's at the time, you said: "This is one of the most robust structures we have seen."

[*Laughter*].

Khalid: I don't remember saying that, but if you say so!

Rizwan: It's undeniable that the majority of Sukuk issuances – I think 96-97% - are asset-based. And the investor community, particularly in the region, they are more fixed income than securitization investors. Similar product but very different investor types. I think the point being that it takes a particular type of issuer, who are inclined in that direction, to actually take the step to do an asset-backed deal. It is the bankers who would probably need to tell them that there is actually an investor market out there for an asset-backed issuance, despite the fact that the vast majority are asset-based.

Mohieddine: If you take a high level view of Islamic finance today, the biggest beneficiaries have been Islamic banks, and most of these Sukuk are being structured for Islamic banks, and those banks have treasuries, and they prefer these asset-based structures. So overwhelmingly, most of the issuance is being made for them. I think other investors – private banks, high-net-worth individuals, other investment management companies like us – would be very happy to look at anything that would give us additional yield, or if there was a comfortable security package we would be very happy to get involved. This is why I was saying: if you want to have more depth and more risk sharing, different types of Sukuk, then you really need a different investor base and we need to mobilize that – we need legislation, we need all these other things to happen. So, I don't want us to paint a picture that these types of structures are going to have a lot of demand,


Basheer


Mohieddine

because frankly we need to work to actually create that demand.

And also, not to take away that these are very exciting legal developments, but again whether we are looking at the GCC broadly or even looking at Southeast Asia, the fact remains that the legal infrastructure is actually one of the main challenges. Investors don't have that much confidence in perfecting securitization – especially in a country like Saudi Arabia.

Nabil: Well this is going to be a game-changer, I think.

> *"The fact remains that the legal infrastructure is actually one of the main challenges"*

Moderator: Can we get a response from the regulator on this?

Basheer: Lack of legal infrastructure is not a challenge in the DIFC. Last year we saw the first Sukuk issuance program establishment based on securitization, and we think that the structure was quite unique as compared to the other Sukuk that we have approved, at least from its regulation point of view. Basically, the Sukuk issuer is based in the DIFC and behind it is a lead arranger which engages banks to purchase gold from the open market using the proceeds from the Sukuk issuance and the gold will then be shifted to DMCC, located in another free zone in the UAE. The relevant local laws that impact securitizations do not apply to such transaction structuring done using the free zones, which means that one can actually issue asset-based Sukuk in this region. It is established as a program for now, although I think they have not been any drawn down on the program as yet. Therefore, I think that this is an interesting innovation that we have seen so far.

Moderator: Is that an example the banks would be interested to follow?

Ahsan: We did the first securitization a long time ago. The point that has been made is that it is a different market and caters to a different investor base. So I don't expect that suddenly the traditional fixed income investors, which here are banks and asset management companies, will suddenly start to shift interest. Yes they will look at it. But again, who are the issuers who are likely to do securitizations? The Sukuk market is driven by high-grade issuers today – whether they are sovereign, quasi-sovereign entities, large corporates or financial institutions.

These are the primary issuers. So when you go down the credit curve and you go to either unrated issuers or limited disclosure issuers, and then try to bring the security package in there and rate the issue solely on the strength of the security package, will the traditional investors be comfortable buying it? It's a test to be done, but I don't think they will readily jump into it. Yes there is a market out there in some places. It's a limited market currently as others will testify. The problems of the past in the global securitization market mean that market has shrunk, however. In the Sukuk market we never really tested it, we did a couple of securitizations and some financings but then the market died – because the conventional market died. So we have to go and test it. Yes there will be a few issuances, but will it become a mainstream market in the near future? I don't think so – it will take some time for this market to develop.

What I do think is worth making the point is that earlier it was difficult to convince the investors or the rating agencies to look at these structures because of the problems in the legal system. That can be solved in an innovative manner because now you have the DIFC, you have English law, and you can work around some particular structures. From an investor perspective, I think it will take some time to rebuild that market and probably as the conventional markets build up, then the Sukuk market will follow.

Moderator: We are also seeing Dubai increasingly grow in stature as a listing center – we just saw the Emirates Airline Sukuk list in Dubai and London and we are seeing more of that happen. What is attracting issuers to Dubai and can we get the views of the panelists on what Dubai needs to do to attract more issuers to come?

Rizwan: I think for Dubai to grow in stature as a hub, particularly for issuers and investors, I think they need to create a domestic demand away from just the Islamic financial institutions, banks and asset managers, that buy Sukuk right

now. We need to create a platform where the current investors such as the pension funds, the Waqf or the other sovereign social funds can also participate – I think at the moment there are restrictions where they cannot. Once we create that investor base I think that it will raise the stature of Dubai, and widen the community of investors.

The other side of the coin is creating an enabling environment for issuers to come to DIFC – and I think the challenge for Basheer and the team here is to graduate from being a secondary listing jurisdiction to being a primary listing jurisdiction, and I think that will come with time and experience. But that is really the challenge.

> *"Speed of review is one of the main driving factors for listings"*

Moderator: And if that is the challenge, how can it be met – what steps need to be taken and what steps are being taken in order to address that?

Basheer: When looking at the overall structure of the fixed income and Sukuk market framework, we have reached out to the advisors and to the banks' representative, the Gulf Bond and Sukuk Association (GBSA), and often what we hear from them is that when it comes to the fixed income and Sukuk markets what they really expect the regulator to do to make it attractive for the listing of those securities is, they want simplicity in the process, they want efficiency, and they want a quick turnaround time. Speed of review is one of the main driving factors for listings – Our processes timeline is comparable to other international markets and best practices and we are continuously working towards how we can simplify the processes and documentation. There are also other factors, one relating to cost of listing and the approval fees for debt and Sukuk transactions. We are in the process of rolling out the new fee structures soon that reflect our cost structures. Overall, I believe the DFSA has put in place processes and procedures to accommodate and help grow the Sukuk market.

Ahsan: I would also attest to that. A few years ago when we used to approach NASDAQ or the DFSA for listing, the process was time consuming and it was challenging from the issuers' perspective as they are used to Ireland, London or Luxembourg style. Because these jurisdictions have been doing it for years through the bond market, the processes are very streamlined, very fast turnaround times, etc. The lawyers would handle it independently and it would be done very quickly, not requiring the involvement of the banks or anything like that. Here, initially, it was a bit challenging, but now the process is very streamlined, we just go through the motions quickly, even the cost structure has been improved and has been waived for certain types of issues, so that's what why we have seen the listing of IDB Sukuk, Hong Kong Sukuk and so on, over the years. So things have improved significantly and I don't see any impediments now to listing issues on NASDAQ Dubai. And they are moving away from being a secondary listing center to a dual listing center, where issuers will simultaneously list on two or three exchanges – and we are seeing more of these.

Khalid: Something that I have come across that I think would be a complete game-changer on the demand side, and it's quite controversial, but there is this gratuity system here that in some ways is a bit like a funded pension. When you leave your job, your company has to pay you X months of salary. I was speaking to someone who said that basically these are all unfunded, if the company went bankrupt its employees would lose that redundancy pay-off. So these corporates really should be putting that money into a fund or an investment in order to protect and grow it. If there was legislation across the country to say that every corporate had to do that - and even though you can imagine every corporate would be pushing back because this is working capital for them – you would suddenly create this huge funds market, with billions and billions of dollars seeking to go into safe or relatively low risk instruments. This is something I've come across before and given that there is no pension market here, this could be a significant influence.

Mohieddine: And remittances as well, are ultimately a major drain on many of these GCC countries with their very large expat populations. So I think that there is enormous potential that is not being captured. I am not being negative and I don't want to take away at all from the tremendous success that we have seen in Dubai or the DIFC and what all the different market participants do. But I think we have to recognize that when it comes to finance, or the financial services industry in general, we are underperforming – we are not operating at the same level here as logistics, airlines, tourism, and all of those other sectors which are really competing on a global scale. We are all proud of the accomplishments of Emirates Airlines and DP World and the telecom companies, they are all doing fantastically. And you look at their ambitions – Dubai Airport wants to build US$50 billion over the next five years. We are talking about numbers that frankly the local capital markets cannot currently accommodate. So we are talking about a real structural risk. If they have to resort to external markets to fund this, then they obviously become vulnerable to the volatility that is then generated in those international markets and this would have a disproportionate impact on Dubai. These are risks, and I don't think we are really dealing with them. We need to recognize that and from a policy perspective we really need to work hard now on trying to develop the financial sector. If we don't, I think we will ultimately do a disservice to the wider economy. And it's a win-win situation right now. Everyone benefits if we really focus on the sector. While we have had good success and we have been moving forward across the region, we have missed opportunities and we need to recognize that.

Moderator: And we will move on to discuss regional positioning in a few moments but first, does anyone from the floor have any questions to put to the panel on this topic?

Audience member: I've heard you talking about unsecured Sukuk and about securitization – but there is something in between, which is the secured Sukuk – i.e. it is not structured, it is like a secured bond. Is there potential for that to expand and could exploring that satisfy some of the aspects that the unsecured Sukuk are currently facing? From a legal point of view how do you see that? From a ratings perspective we have seen very few, perhaps just one. Is that something we might see more of and is it worth exploring?

> *"In terms of a pure corporate issuing secured Sukuk – it is possible"*

Rizwan: I can answer from a legal perspective, and I will ask the banker to step in as well. I am sorry to get a bit technical but to answer your question, it comes down to how you define asset-backed. Normally, in a loose definition, asset-backed is when you have an underlying asset that is credit-enhancing for your Sukuk. So you have a senior unsecured and then you are supported by an asset: be it real estate, cash flows, whatever it may be. What makes it a securitization in essence is that for that asset-backed issuance the cash flows are also segregated and made bankruptcy-remote. From what I understand, your question is: forget the segregation of the cash flows, do I have an asset that I can recourse to in the event of a default from my issuer? This is still an asset-backed issuance, but secured rather than a securitization. The view we take is that a lot of this asset-backed, non-securitization issuance is purely a credit enhancement. So the issuer is perhaps not strong enough on its own or the cost of borrowing for the issuer is substantially higher on its own, and that needs a bit of credit enhancement. Does this reduce the cost of borrowing and are we seeing any of that? Well we are, but we are seeing it in a slightly different way. We are not necessarily seeing it supported by assets, but we are seeing it supported by guarantees from sister companies, that are perhaps in better shape with better credit or a better balance sheet, who can provide a guarantee that ultimately may help reducing the cost of borrowing.

Ahsan: Yes, we are already seeing credit enhancements in some Sukuk structures, for example project finance Sukuk. Most of them have some sort of security that is shared across the various types of facilities – even between the conventional lenders, the Islamic banks and the Sukuk investors. The recent Emirates Airline Sukuk was guaranteed by the UK's ECA and that acted as a credit enhancer and resulted in a better pricing for the issuer. So you already have these types of Sukuk. In terms of a pure corporate issuing secured Sukuk – it is possible. Will the investors go for it? Yes, the investors would like to have it. The question is whether the issuer really wants to do that – because they might have other senior unsecured borrowings with negative pledge covenants, etc. That's why it is suited better to projects, because the financing itself is for a particular project so it doesn't affect the negative pledge covenants of the sponsors and so on. So while there may be a few secured or credit enhanced Sukuk issuances, I don't see a major shift in the market because the primary issuers in the market today are the sovereigns, the quasi-sovereigns, financial institutions and highly rated corporates.

Rizwan: Yes, sometimes issuers will say, well this is going to shrink my balance sheet, if I assign this asset or this real estate, and I don't want that.

Audience member: I understand it is mainly on the project side, but is it easier to structure a Sukuk like that? For me, I don't like the term asset-backed, I prefer to refer to it as obligor (based on direct recourse to the rating of the obligor) or is it depending on the assets. These are the two extremes and in the middle we have the credit enhancers. Is this something that can help a Sukuk be structured in such a way that it is more appealing to a Shariah board, because I can see that Shariah boards are becoming more stringent in the way that they structure Sukuk – so is having that layer helpful?

Ahsan: It's not necessary. The one end of the spectrum is a normal senior unsecured asset-based Sukuk, and the other is the secured Sukuk where you have recourse to both the obligor as well as the underlying assets. And the middle is something called securitization where you don't have recourse to the obligor, but you do have recourse to the underlying assets. So there is a full spectrum, and Sukuk, like any other bond, can be structured to meet all of these types. The point is where does the commercial requirement of the issuer and the investor lie? When we structure these, we have to see where is the commercial requirement between what the issuer is willing to give and what the investor is willing to buy. So today the primary end of the market is senior unsecured structures, but for specific usage and specific purposes we do have credit enhanced Sukuk, we have project finance Sukuk, etc. We have seen many types of innovation and credit enhancing structures – either in the Sukuk format or as a syndicated loan format.

Moderator: Given that we've already touched on the question of structuring, let's move on to that topic. We are seeing increasingly sophisticated issuances coming out – so what kind of trends are we seeing in terms of innovation in structure – where are they coming from and what's driving them?

Nabil: We are seeing quite a few things. I'd like to talk about the Drake & Scull Sukuk in terms of a very innovative structure. But a lot of my focus has been outside Dubai in the rest of the region, funneling using DIFC or Dubai structures to improve the sellability of the Sukuk, creating a security that is needed, to the extent of a credit enhancement etc, where others have said that is impossible. So again the DIFC SPV structure. One of the challenges in Saudi in particular is that there is still some tax leakage – when money flows out there is still a 5% withholding tax. In an ideal world there would be some sort of treaty to improve Dubai as a financial center for Sukuk; but assuming that is not going to happen, another structure we have created has been Saudi Arabian CMA funds. One of the fascinating aspects of combining a CMA fund with a Sukuk has been that as of today at least, funds are a tax and a Zakat-free structure in Saudi Arabia, so normally for foreigners there is a 20% tax on profits at the Saudi level – for GCC there is a 2.5% cap at that level plus there is a 5% holding cap when the money leaves the jurisdiction. By having a CMA fund however, as of today, a CMA fund is both tax and Zakat free. So at times we have created a structure wherein the Cayman entity is the unitholder in the fund, and then money flows out to the subholder, and then we are creating a structure that takes advantage of local rules, having a Saudi entity own it, with foreign holders at the Cayman level in a way that is very tax and Zakat efficient compared to structures in the past, and creates a higher level of security. So we are seeing quite a bit of innovation combining different worlds, from the funds world and the SPV world combining with the Sukuk world. That is new, in the past everyone was in their silos – people worked on Sukuk, on funds, of DIFC corporate structures. By bringing some of these together I think we are finding brand new ways to do things that haven't been done before.

Rizwan: The Drake & Scull issuance recently was a private placement, but they have talked about it in the public domain. It was a pure commodity Murabahah Tawarruq structure for a Sukuk not necessarily to be traded in the secondary market. But it was the first time the NASDAQ Murabahah platform was used rather than going to London for the LME for the exchange of metals. The utilization of that platform allowed 1) support for Dubai to become a hub; and 2) it allowed us to limit the timezones of where we were dealing with for the transactions, because all the parties were in Dubai – the issuers, the JLMs and all of the parties. So the trades did not have to take place on the LME; they took place on the NASDAQ platform. It was a question of sitting down and understanding the process. The NASDAQ Dubai platform also tweaked their mechanics towards us to allow the transaction to take place in real time, and there was a slight anomaly there – certificates of US$10, which were the underlying asset plus, rather than metals. If you are doing a US$120 million Sukuk with US$10 certificates to be traded every time, then you'd probably have to employ someone full-time every three months to be able to do those trades. So it was about sitting down – the folks at the platform went in and rectified a few things, although they could not increase the scale of the certificates' value because those were already issued, so it would require too much administrative hassle to do that; but I think over time those minor headaches can be fixed. To be honest since the Dubai platform was used, I would not be surprised if even the national bonds would set up their own platform to facilitate a commodity Murabahah platform, so NASDAQ Dubai might see some competition.

> ***"We are seeing quite a bit of innovation combining different worlds, from the funds world and the SPV world combining with the Sukuk world"***

Moderator: Ahsan, what trends have you seen in terms of Sukuk structure – I know in particular the significant trend this year and going forward is Tier 1 capital increases on the back of Basel III. Can you give us an outline from the banks' perspective?

Ahsan: Yes, we are seeing both new formats of structures and new Shariah structures. In terms of innovation: corporate hybrids, Tier 1 and Tier 2 capital issuances, ECA-backed Sukuk, project finance Sukuk. In terms of the Tier 1, as Khalid mentioned, we are seeing more Islamic banks come out, as we are seeing in general more banks in the Middle East come out with Tier 1 issuances; because as the regulators do more stress testing, etc, they will try to boost the capital levels. Bear in mind that today the capital ratios of most Gulf banks are quite high, they are well above the capital benchmarks. But bear in mind the comparison. If a bank in Dubai has a capital ratio of 15% and another one is falling to 13%, then that bank will try and keep it up to 15% so they will go out and issue Sukuk because when the rating agency rates them they will also look at peer comparisons. So that will drive Tier 1-type issuances; not just from the UAE but from other countries in the region.

In terms of other types of innovation, let me talk a little bit about innovation in Shariah structures as well. Initially, we had plain vanilla Sukuk based on Ijarah or Wakalah for financial institutions. Some of these innovations on the hybrid structures also have flown through on the Shariah structures. So the Tier 1's are based on Mudarabah, for example, which is more suited to equity-like structures. Or in Saudi we have the combination of Mubarahah and Mudarabah. We have also seen structures based on a combination of shares and commodity Mubarahah and Ijarah, etc. So the trend is towards asset-lite structures where the use of fixed assets is

minimized, because entities don't have an endless supply of fixed assets, and they also need to preserve some for future issuances. So even though the sovereigns may have a big supply they want to preserve that and they want to innovate, so we have seen hybrid structures on the sovereign side as well as on the corporate side; and we will see more innovation there. Similarly for industry-specific issuance such as the airline industry, we now have one particular type of structure based on rights to travel, which has now become the industry norm. The telecommunications industry again has a type of structure based on airtime, which has become the norm. We might see some more structures for some specific industries which operate on a business model that has some sort of tangible assets – that are not fixed assets, but are considered tangible from a Shariah perspective.

Moderator: Are there any other significant aspects here – for example longer tenors, or I know we are seeing some bigger issuances come to market, we are seeing international deals come out frequently. Khalid, what are you seeing on that front?

Khalid: If you look at the PETRONAS Sukuk for example, what we are seeing in the Sukuk market is that as it becomes more global and more accepted is that, whether it is a strategic goal of Malaysia to develop the cross-border market, issue more and larger volumes and support its own market; or issuers are looking to tap new capital markets as they expand outside the capacity of their own domestic markets, I think this is a broader trend that you will see more corporates, the larger corporates, go towards cross-border issuance.

Nabil: I would say that we are all seeing a trend that some of the parties are getting less and less comfortable from a legal point of view with – let's say with the Ijarah Sukuk, in Saudi and elsewhere, where there wasn't a true Ijarah happening. On one hand there was a Shariah point of view that the asset has moved over and there is a lease there, but from a legal point of view that is not the case, the land has not moved over; so call it Ijarah if you want from a Shariah perspective but from a legal view that hasn't happened. So we are seeing more hybrids, Mudarabah, Murabahah mixed hybrids increasingly used, particularly in Saudi and increasingly elsewhere.

Moderator: So you mentioned Saudi Arabia – where are the growth hotspots now and where are the interesting markets for Sukuk and what about newer players such as Turkey?

Mohieddine: Well I think that is where you have a lot of potential, where you see some of the larger emerging markets come in with sovereign issues, as that unlocks a lot of opportunities for banks, for corporates and so on. Pakistan, South Africa, Turkey, Morocco, Tunisia, possibly Egypt. There is no shortage of issuers that can come to the market and I think that trajectory is now firmly established and I think that will continue – more sovereigns, more corporates, more types of deals coming in. The challenge obviously is for the market to grow in a stable framework, and I think that is what we need to be focusing on. And I would also say one thing about what Dubai and the region can do to be more firmly established on a global scale. I think in terms of banks promoting consolidation would be really useful. We talk about banks not having a wide enough specification and this is one of the key challenges; and I think many of the banks are focused on one area or one emirate. Anything that can work towards creating larger banks, regional banks, regional stock exchanges – this will bring scale and make this region more attractive to international investors and issuers, and would go a long way. I don't think we have moved the discussion far enough on that front, and it would be nice to see some tangible progress.

Moderator: Is that something we could expect, or that could be facilitated?

Khalid: In terms of banking consolidation the thing is that banks are profitable, they make lots of money, and no CEO wants to give up his job! The pressure for consolidation really aren't there, here – even the smallest banks are still profitable. Bahrain is where we have seen some consolidation because you have an overbanked market, a relatively small domestic market and banks are struggling. You need those drivers to rationalize consolidation – in Bahrain the regulators want fewer, stronger banks and they have encouraged that. But also here, in the region, the governments are often the largest shareholders in the banks, so it also needs to be a top-down driven policy objective to say OK you two guys merge because I want our local economic power to extend to this country or this emirate. And so it is still quite partisan and I can't see cross-border mergers happening between the larger guys, as they are quite protective of their own systems and territories: and I don't think that will change any time soon.

Ahsan: There has always been talk of an Islamic megabank and whether it should be started from scratch or by a merger, but it hasn't come to fruition as yet. An Islamic megabank would have more underwriting power, a bigger balance sheet, and could compete more effectively with the big global banks. But bank mergers have their own issues so it is difficult to predict when it would happen.

Khalid: It's only trouble that puts the political drivers and the pride aside.

Mohieddine: But this is exactly what you need to change – you don't want to be reactionary indefinitely. I think this is the whole point – we need to be proactive. We have visions set up and now we have to recognize that although it's great that we have a leadership that is ambitious in spelling out that vision, delivering on that and moving forward it would be nice to see more proactivity.

Nabil: I think there is almost too much focus in this industry on the billion-dollar Sukuk and while it is very exciting when you see GACA in Saudi Arabia do a very large issuance and it's taken up 100% locally and we see numbers in the billions – that's great and exciting and wonderful, but I think the industry often overlooks the medium-sized companies. I haven't studied the Malaysian model but we were in Saudi Arabia

a few weeks ago working with fairly large medium-sized companies, and you tell them they have the option of Sukuk and they get excited and they want to talk to the bankers. And to be honest, the bankers give them a bit of a cold shoulder. So then the question becomes – OK, we need to grow the industry, we need to find way of doing more Sukuk. I think we are ignoring a very large portion of the corporates that are out here in the region that would be very interested to tap another form of liquidity, because the banks are falling over themselves to lend to the big guys for almost nothing, but these smaller firms – and we are not talking about tiny firms here – who would be very keen on a structure that gives a credit enhancement to give holders a bit more comfort, who would be interested in doing something a bit more bespoke, who would like to figure out a way to tap into the property they own, despite the foreign investment rules, and get income-producing streams from it. But over and over again, the same corporates I see telling me, well we went to speak to XYZ and they all said we want to hear the 'b' word (billion), come back to us when you are a bigger company. But when they are a mega-sized company they probably won't even need to do a Sukuk anymore!

Mohieddine: I think we are beginning to see the development of sub-investment grade or corporate or high yield issuance – we have had a number of transactions and I think broadly speaking they have been well received and they have performed fairly well. But I think that without a doubt we have a very steep credit curve, and the minute you go down the cost becomes significantly higher for these companies, so they start weighing it up – do I do a short-term deal with the bank for a while, or do I really need to pay out that much for my first deal, where I don't have a rating, and it will be a lot more complex. So that transition I think is suffering, because institutional demand for that type of asset is not very large so it becomes difficult and expensive for many of them to come to the market. So you get government-linked and blue chip companies coming to the market for just a few basis points, while smaller companies end up paying 400-500 basis points.

Malaysia I would say is not that different, but the principal difference is that they have much more local liquidity. That local liquidity is geared towards local issuance, so there is a natural buyer. Any company in Malaysia that wants to issue has a pool of liquidity waiting for them. But even in Malaysia, we find that it's restricted – to local currency of single 'A' rating and above. If you fall down much below that then it dries up. And we could argue about what is the best model. Ideally you want a combination of both. If you have a lot of local liquidity chasing too few deals, then it makes the market unattractive for investors. So in Malaysia, it's really only local buyers for that market because for an outside investor, you are not compensated enough for taking that extra credit risk. Why buy local when you can buy government, and forgo 25bps, which is typically what you would get paid for the credit risk.

But then there is the other extreme, where it's all international and there is no local. So when I look at it, I feel that the Malaysians should be doing more to promote independent and dollar issuance and bring in foreign investors and promote non-local and international issuance. And in our

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part of the world we need to do much more to develop local markets, and create local demand pools and create local issuance.

Ahsan: Why is the market not there for mid-sized companies? The market today is geared towards rated businesses. I know that the domestic Saudi market is largely unrated but if you look beyond that at the wider GCC, the public issuance market is primarily for rated corporates. For unrated firms, the pricing advantage of a Sukuk may not be much compared to bank financings if that's their primary motive. And the deal size also needs to be large enough to justify the costs involved, say legal, listing, etc. Also from a liquidity perspective, if you are entering the public market it has to be a minimum of US$300 million or it doesn't qualify as a benchmark issuance. So can you structure a Sukuk for these companies? Yes. But it has to be a private placement or a club deal targeted to a select pool of investors. You really can't do a public issuance for a smallish, unrated corporate looking at just US$100 million or so. It would more likely be a syndicated or club deal in a Sukuk format. And we have seen such issuances come to the market.

Mohieddine: I agree with everything you say but the issue is why that market doesn't exist. How do we rectify that situation? There are indeed pricing realities and that is just a fact. The bank is providing them a service by telling them the truth – that this is going to cost them more and be expensive. So we have to go back to policies – stakeholders and regulators need to come together and find a way of mobilizing this segment. If we are going to remain as we are today with the banks' treasuries being the primary source of demand, then you are going to get products that serve that demand: which are five to 10-year, very highly rated, senior unsecured-type papers. If we want to see the Islamic finance market and specifically the Sukuk market evolve to have more risk sharing, and the asset class becomes one that can perform throughout a business cycle, be different to pure equities, different to fixed income, we want to start funding SMEs, we get the development going to boost the economy – then block by block, legislation by legislation, we have to work on all these different things to create that institutional market that is currently not there. And once you succeed in doing that,

then a lot of things I think will fall into place; and everyone benefits as a consequence – from the lawyers to the bankers to the regulators and ultimately to the individuals. We cannot forget that this is all aimed at facilitating economic growth and creating employment and all the different things that our society desperately needs today.

Moderator: All excellent points and I think that was a valuable discussion. Now perhaps we can move on to looking forward. We have talked about the current situation, and the key issues and challenges. Now let's discuss the opportunities. Especially we saw in 2014 the year of the non-Muslim nations coming to market with sovereign Islamic issuances and we are seeing increasingly participation from a wider variety of countries. What do you think the outlook will be for this year – will the corporate side step up? Will we continue to see this development across non-Muslim jurisdictions, both in developed and emerging markets? What can we expect for 2015 and what role will Dubai play in this? At the moment Dubai is creating a lot of ties – in the last few months they have signed agreements with Luxembourg, with Belgium, with France – will we see more of this active cross-border promotion as well?

Rizwan: I think all of that is very true. Looking at 2015 the pipeline for listing is healthy and we have seen quite a bit of interest. As we speak, we have about half a dozen Sukuk transactions that we are processing that will be coming out for listing in the next couple of weeks. I think one of the things we are preparing ourselves for is that in the case of Malaysia, the regulators have moved on to allow bonds to be offered to the retail market, and we have also seen in the UAE there is a sort of retail bond offering which is the National Bond Saving Program. So the question we have to ask ourselves is – what are we looking to achieve and what are the risks we will be faced with if we offer Sukuk through this channel? So this is the situation we are preparing ourselves for – potentially a retail offer. We have not seen anything come through as yet, but it is on the horizon.

Moderator: Thank you. Before we wind up, let's go through our panel – all of whom are from very different areas and have diverse approaches and perspectives – and find out your outlook, hopes and expectations for the Sukuk market in 2015.

Ahsan: In terms of 2015 going forward, some of the trends will continue: of new countries and non-Islamic countries coming to the Sukuk market. Of course the timing will depend on how fast they are able to amend their legislation, their regulatory environment and their taxation laws to accommodate a Sukuk issuance. But we will hopefully see a few more come to market. We may also see a few more innovative Shariah structures, in terms of the types and format of Sukuk – whether Tier 1 or project finance or ECA-backed Sukuk. In terms of corporate issuance, we have already started to see the private placement format becoming more active for some of the unrated, unlisted type of deals. Because of the general awareness and requirements of the corporates, they do want to move away from pure bank lending, to get longer tenors and to access an alternate investor base. We have already seen some private placements in the market and these will become more frequent – you may not hear too much in the press about them but they will become a much bigger component of the market. I would also really like to see a retail Sukuk – Malaysia has started, Pakistan has started. It would be a nice add-on to develop the market. There are challenges, both in terms of pricing and of distribution, and other regulatory issues, but hopefully they will get sorted out soon.

Nabil: I would agree with you that we are seeing a lot more privately placed Sukuk – we are seeing this in Saudi Arabia as well. Quite a few mid-sized corporates are trying to see to what extent foreign money can come in, trying to take advantage of some of the structuring, the CMA funds structure. There has been some discussion with one party about doing a retail Sukuk using certain assets in the hope that parties outside Saudi Arabia can access that market through CMA structures. There is a lot of interest in that for obvious reasons – creating indirect ownership, particularly for parties from Malaysia, Indonesia, Brunei. Also thanks again to DIFC as we were discussing earlier, we can now present new asset-enhancing structures that didn't exist before, and we are seeing a big jump and a strong interest in securitization in general.

> ***"Because of the general awareness and requirements of the corporates, they do want to move away from pure bank lending, to get longer tenors and to access an alternate investor base"***

Rizwan: In general I agree – we will definitely see more private placements and we are already working on quite a few which are substantially larger in volume than any we had in 2014, so it is definitely a growth area and this will be the big story for 2015. Going down to a more granular level, I think we will see more issuance out of Turkey – a lot of the participation banks there are already looking at their capital adequacy ratios, to tap into the capital raising opportunity and Tier 1 issuance. And as Nabil mentioned, we are looking at several securitizations out of Saudi which are both exciting and challenging.

Khalid: Nothing much to add that hasn't already been touched upon. I guess on the bank side, additional capital instruments to help boost capital levels in advance of Basel III. But also in the more government-dependent jurisdictions

like Qatar, Abu Dhabi, perhaps Oman, where government deposits are a large part of the funding profile – as those reduce, we will see more senior unsecured issuance for those institutions. Globalization in the markets again, a key issue – we will see more non-Islamic sovereigns. The Islamic capital market has become a phenomenon, and once those guys have entered it is a game-changer in terms of the size of the market. While it is limited to Muslim countries it is a relatively niche market, but when other stakeholders are seen to participate then it transforms it. I am looking forward to China coming in. When you have those high profile names, even people who aren't interested will look up – if the UK is doing it, then why aren't we? – we should be in that market as well. It has a ripple effect. The Hong Kong one was the first dollar issuance out of Hong Kong in years, so it brought in a lot of investors – and not just because they want to invest in Sukuk, but because they wanted Hong Kong bond dollar exposure. So it forces more people to look at the format, and to become comfortable with it, and that will be a strong positive trend. And then as mentioned before, still on the theme of bank funding, as easy and cheap funding for corporates dries up that will push them out to the capital markets.

Basheer: The total global issuance of Sukuk is probably close to US$300 billion and in order to bring this market to the mainstream, there are some additional issues that have to be resolved., One of them is this often debated question about standardization of documentation, and getting the scholars to agree on a uniform approach is vital to the success of bringing this market mainstream. There may be Shariah opinions that would need to be standardized for the Sukuk markets to grow. From the regulator's perspective, we are doing what we can to help in the standardization process e.g. by participating in a working group recently formed by the Islamic Financial Services Board, looking into cross-border issues affecting the growth of the Sukuk market, and we will volunteer our feedback where relevant. The other aspect we observed in recent times is that when issuers are coming for listing in DIFC, they want to come under the Exempt Offeror structure that we have put in place. This is where we recognize any particular jurisdiction, i.e. government issuer as Exempt Offeror and where we don't require the issuer to comply with our requirements. The normal process of prospectus review and other requirements therefore do not apply. Currently, we have a few queries coming in on Exempt Offeror Sukuk issuers, but we still have to examine them carefully if they qualify as one. In addition, there are a number of applications that we are considering. Overall, the outlook is looking good, at least for this quarter.

Mohieddine: It's tough to add to all of that! But I do think that innovation and growth is needed from a market perspective. In terms of market performance, I think the outlook is mixed. We are in a challenging environment – more challenging and uncertain than last year. And in terms of asset gathering, I think we need more success on the institutional side, and I think we will see a continued challenge on the retail platform as we try and build scale there. But broadly speaking I cannot help but be optimistic over the medium term.

Moderator: Thank you so much to all our panelists for an exceptionally insightful and rewarding conversation.