Securitization: the Fastest Growing Debt Market in the Middle East

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Agenda

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  - Impact on Region
- Key Sectors to Drive MBS/ABS Growth in the GCC, MENA
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  - Housing Finance
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- Secondary Market for Securitization
- DIFC's Role in Promotion of Securitization

Size and Scope of Market for Structured Products

- Mortgage-backed securities (or MBSs) are the driving force behind growth in global markets (dominating them in terms of value), while asset-backed securities (or ABSs) are the more diverse range featuring steady growth rates.
- The US is the unchallenged world leader in securitization markets w/ total asset value tallying $8.6 trillion in 2006 (or 6.5 trillion in MBSs vs 2.1 trillion in ABS issuances), or more than ¾ of the world total.
- New issuances in Europe are equivalent to 19% of US issuances in 2006, with the UK the largest European issuer by far.
- In Asia, South Korea is the 2nd largest market after Japan, w/ other markets emerging in Taiwan, Hong Kong, Malaysia, Singapore, Thailand, & China.
- Securitization in Latin America is expanding mainly in Brazil, Mexico, & Argentina.
- Eastern Europe, Middle East, & Africa are the new generation of securitization markets w/ much of the current activity happening in Russia, South Africa, Egypt, GCC, etc.
- The MENA region, accounts for a mere 0.2 percent of the global securitization market.
- The development of securitized markets in the MENA region could boost the function of financial markets as an engine of sustainable economic growth.

Lessons from US Sub-Prime Crisis

- **Underlying Problem was One of Split Responsibilities:**
  1. Widely dispersed risks through use of complex illiquid structured products has made understanding of nature of securities (market value & credit worthiness of assets backing them) very difficult.
  2. Problems surrounding role of rating agencies in assessing underlying risks have left investors skeptical about validity of ratings $\Rightarrow$ Call for:
     a) Significant increases in public access to performance reports, and/or
     b) Clearer basis for credit rating assignments
  3. Securitization distorted incentives of loan originators, allowing for poor quality lending (principal-agent problem)

Regional Resilience Amid Fears of Contagion

- **Meltdown in US mortgages unlikely to impact local markets, given:**

  1. Region's limited exposure to US sub-prime loans;

  2. Strong key vulnerability indicators (vs. those for last 3 emerging market

Africa/Middle East External Vulnerability Indicators* (%)	**1994**	**1997**	**2000**	**2007e**
External Debt/GDP	44.9	40.1	35.2	21.3
Short-Term Debt/Reserves**	2.8	1.4	0.8	0.4

  3. Rampant liquidity and the ensuing reduction in borrowing needs;

  4. Robust residential mortgage growth and real estate boom;

  5. Increased spending on LT economic development and diversification;

  6. Greater intra-regional trade and investments;

  7. Improved growth (and expectations of growth) and B.O.P. conditions;

  8. Increased delinking from US business cycle.

Source: IIF Special Briefing, *The US Mortgage Crisi and Emerging Markets.* *: *Averages are GDP-weighted;* **: *Reserves exclude gold; e=estimate based on data end of August 2007*

New Breed of Securitization in GCC

- Market poised for strong growth with 200-250 billion USD in expectations for total transactions volume in 3 years.
- Key Factors to Drive Growth in Structured Products:
  - Implementation of Basel II:
    - Restructure balance sheet through securitization; reduce gearing in line with capital adequacy requirements; help banks handle mismatch in their tenor; allow for freeing of capital, possibly leading to new lending at better margins.
  - Housing Finance:
    - Tap into housing-finance market growing at 25% per year; increase potential pool of owners; encourage mortgage borrowings, etc.
  - Infrastructure Projects; PPI and Privatization:
    - Increase private sector involvement in provision of public goods given sizeable development porojects (planned or under development) in excess of USD 1.3 trillion; reverse past under-investment in infrastructure projects; allow for easing of bottlenecks that could delay progress, etc.

Construction and Real Estate boom

- Commercial banks are over-exposed to real estate sector and under pressure by the central banks to reduce concentration risk.
- Banks face a widening maturity mismatch between the short-term sources of funds available, such as deposits, and the long-term funding of real estate and housing, exacerbated by raw materials (and labor) shortages that delay the completion of many projects.
- Substantial expansion of residential, commercial/office space is needed to keep up with pace of growth and demographics.
- Banks need to reduce risks stemming from loans to developers and mortgages by offloading these exposures from their balance sheet.
- REITs are being introduced in the region by real estate developers

Project Financing

- **Potential market is enormous: planned project value is estimated at $1.6 trillion; however three issues need to be addressed**
- **Legal framework:** infrastructure fees (e.g. electricity, water, highways, railroads) are set by public authorities, therefore it could be tempting to keep them low (in real terms) to the detriment of investors
- **Risk sharing:** if construction runs behind schedule or incurs in over costs how will the terms of the deal be redefined?
- **Institutional stability:** a project approved by a government might be repudiated by the next one.

Positives of Market based Project Finance

Project financing would introduce market-based practices into public works and improve public sector governance:

- Cost-benefit analysis in selecting projects
- Sound project evaluation
- Institutional accountability
- Less corruption in procurement process
- Better administrative practice
- More entrenched rule of law
- Financial market deepening
- Introduction of best practices

Benefits to Securities' Issuance in the Region

- **Benefits to securitization stem from the need to diversify the region's investor base, bringing benefits to:**
  - **Large-Enough Corporations**: Useful financing tool at lower cost of funds; Off-balance sheet funding technique allowing for deleveraging;
  - **Unrated Companies/SMEs**: Ideal tool to tap into capital markets on anonymous basis;
  - **Sponsoring Banks**: Means to generate fee income w/o increasing size of balance sheet;
  - **Originators:** Method to enhance exposure to particular sectors or business lines;
  - **Governments:** Debt-reduction tool through conversion of assets that may count as part of overall public debt;
  - **Regulators:** Introduction of transparency and market discipline to asset origination & servicing processes;
  - **Investors:** Diversification into new asset classes & along credit spectrum; reduction of exposure to corporate entities; etc.

Legal/Regulatory Challenges

- Dearth of legal basis except in Egypt, Lebanon, etc.

- Tepid involvement of regional central banks in securitization process with little done to institute reforms $\Rightarrow$ current legal environment still uncertain & largely untested.

- Urgent need for more resources allocated to building regulatory framework surrounding structuring, issuance, ratings, sales, and valuation (which would move in line with governments' commitment to a heavier private sector role in the development process).

- Call for transparency to these new product areas to foster stability while maintaining liquidity, supporting further meaningful financial innovation, and capital deepening.

Creation of Secondary Market for Structured Products

- **Only after the secondary markets become mature will securitization win favor with foreign investors.**
- **Introduction of government-sponsored bodies can facilitate market integration process.**
- **Institutions of this type have proven to be profitable & efficient & can be privatized as in the US model:**
  - Fannie Mae (Federal National Mortgage Association): buy mortgages, pool them, and then issue MBSs.
  - Ginnie Mae (Government National Mortgage Association): provide insurance facilities and packaging of mortgage pools to lending institutions.

Human Capital and Professional Competences

- Analysts to assess credit risks and value of collateral
- Accountants to provide accurate information to investors
- Legal professionals to specify clear contractual obligations
- Market makers for secondary market to ensure liquidity
- “Structurers” to design securities tailored to investors needs
- Regulators to oversee the build up of aggregate risk and its repercussions

DIFC's Role in Promoting Securitization

- Sound & efficient listing/trading platform (DIFX, currently the largest Sukuk market);
- International legal & regulatory infrastructure standards with independent risk-based regulator (DFSA);
- Transparency, disclosure, and corporate governance as building block for financial sector development (Hawkamah);
- International best practices;
- Modern and secure payments infrastructure;
- Cluster for lawyers, accountants, and bankers alike;
- Provision of liquidity/ease of access to local/foreign investors, and
- Assistance in establishing required legal and regulatory framework for securitization, spanning all aspects of company law/SPV setup, insolvency law, security law, trust law, etc.

New Draft Regulation on SPVs for Securitization

- The DIFC has produced draft regulation -- currently in the consultation phase -- allowing the establishment of SPVs, thereby filling a gap in the legal framework.
- Although the DIFC does not aim to become an SPV jurisdiction this provision will broaden the spectrum of structured transactions, by providing a much needed legal underpinning and clarity
- The use of SPVs in the DIFC under the new regulations will greatly facilitate sophisticated financing activity
- An Exempt Company (as the SPV is dubbed in the DIFC regulation) will be allowed to undertake only a limited set of activities, namely acquisition, holding, and disposal of assets, whether according to conventional or Islamic rules
- Set up costs and regulatory burden are extremely light.
- Visit: http://www.difc.ae/laws_regulations/proposed/proposed_laws.html

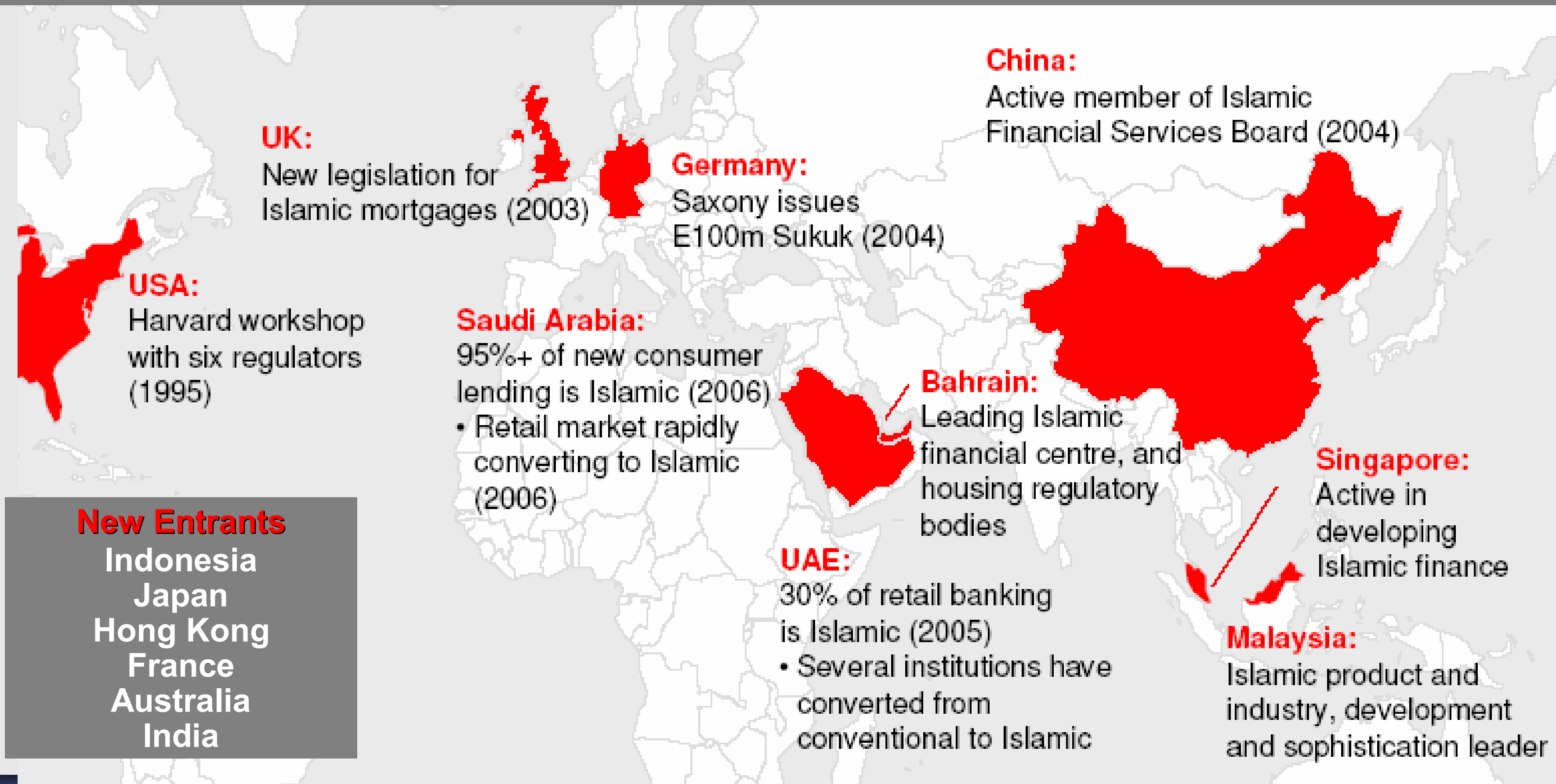
Islamic Finance & Sukuks

- Islamic finance is securitization's new frontier, as stimulated by the upsurge in regional liquidity for Islamic securities.
- Real estate, in particular, lends itself well to providing Islamic & ethically minded investors with projects that can yield returns equivalent and even greater than other markets.
- The Collective Investment and Investment Trust legislation already supports the development of Shari'a-compliant finance.
- DIFCA, DFSA and DIFX have all streamlined the listing of Shari'a-compliant financial instruments, and DIFX is already the largest global Sukuk market.
- DIFC will support the build-up of a government Sukuk market to finance infrastructure & to mainstream Sukuk as a public finance instrument.
- DIFC will assist set-up a Shari'a-based mortgage market to support housing finance in UAE & the region. Its objective is to become the main regional platform for a secondary market in Sukuk and Shari'a-compliant funds.

Islamic Finance Global Development

Total size estimated between USD 800 billion to USD 1 trillion, growing at 15%-20% per annum

Within 8 - 10 years, the industry estimated to capture half the savings of the 1.6 bn Muslim population



Source: HSBC Amanah

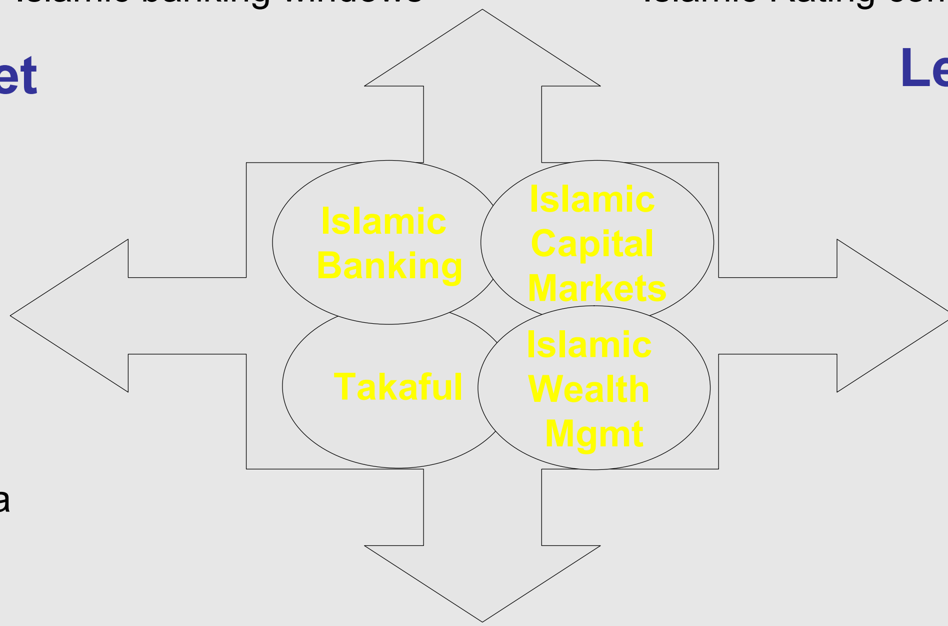
DIFC Islamic Finance Developmental Focus

Institutional Development

- Domestic & foreign Islamic banks
- Islamic banking windows
- Waqf Trust Services
- Islamic Rating companies

Product & Market Development

- Comprehensive product range in banking, Takaful & financial markets
- Global Sukuk listing platform, sovereign & corporate
- Commodity Murabaha Exchange
- Islamic Hedge Funds Platform



Legal, Shari'a & Reg. Framework

- Comprehensive regulatory and legislative framework
- Dispute resolution
- Arbitration centre
- Favourable tax structure
- DIFC Shari'a Center
- International best practices

Knowledge & Education

- Education Centre
- International conferences
- Islamic Finance Portal
- Business Intelligence Centre

Role of DIFC & Shari’a Compliant Finance

- DIFC positioned to be global market for Shari’a compliant finance
- Mainstreaming and creating a market for Shari’a compliant financial services
- Creation of a Government Sukuk market:
  - Financing infrastructure
  - Mainstreaming as public finance instrument
- Develop secondary market in Sukuk and Shari’a compliant funds
- Creation of Shari’a based mortgage market to support housing finance
- DIFC has set clear procedures for authorising Shari’a compliant institutions
- DIFC/DFSA/DIFX have streamlined listing of Shari’a compliant financial instruments
- DIFC has set-up an Islamic Finance Advisory Council (IFAC)
- DFSA issued legislation:
  - to regulate the managed funds industry within the DIFC.
  - permitting setting up Collective Investment Funds in the form of an Investment Trust.
  - to permit the operation of REITS within the DIFC have also been introduced.

DIFC Enabling Infrastructure

- **DIFC is well placed to be the international point of reference for Islamic Finance regulations, standards and practices.**
- **The world's only model law to regulate the Islamic finance sector, with special licensing category for firms carrying out Islamic finance and a Centralised Sharia Board within the DIFC**
- **DIFC Strategy for Islamic Finance addressing key industry challenges such as:**

Talent
Accessibility
Infrastructure
Standardisation
Product Innovation

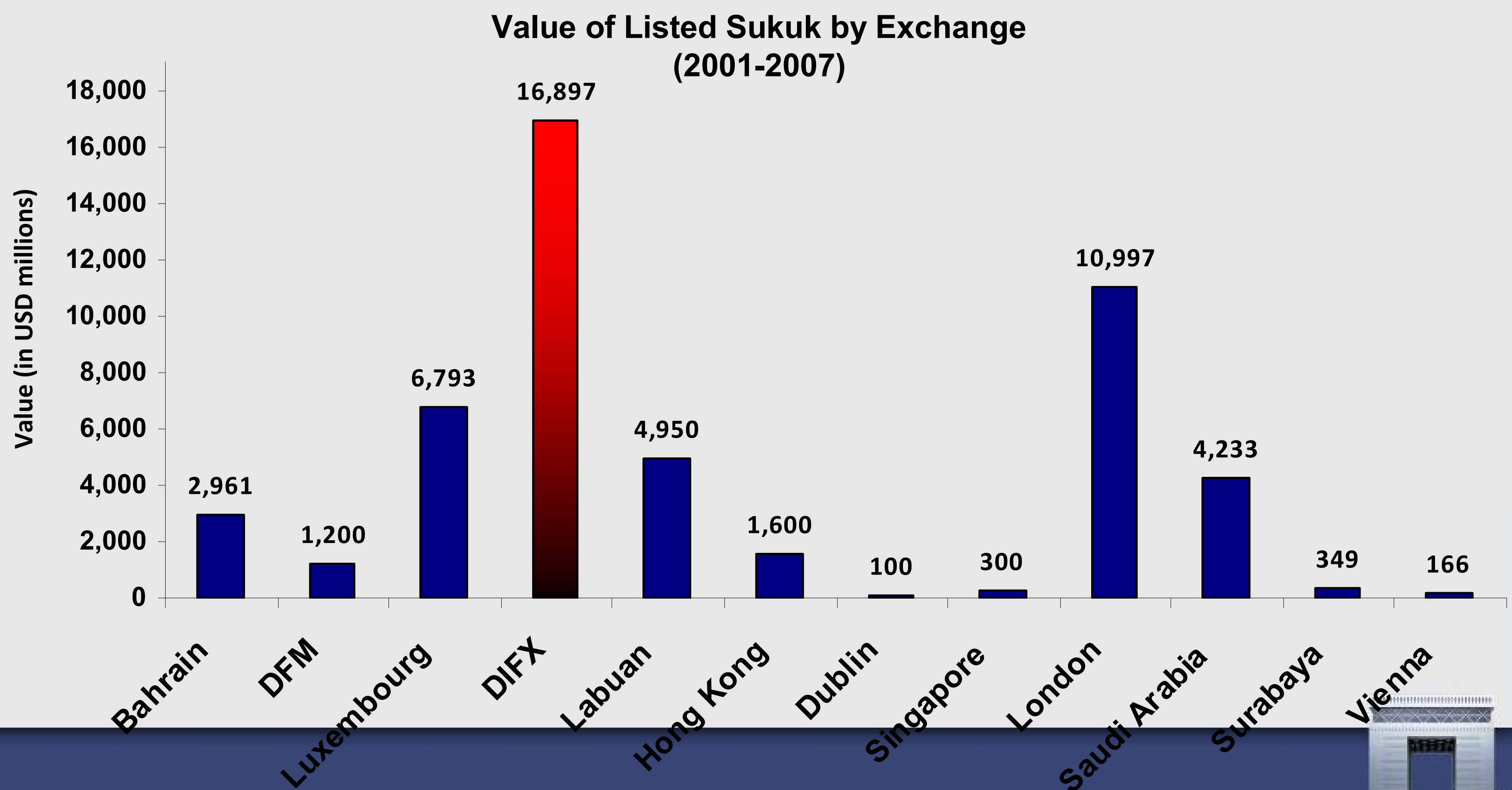
Addressed by
DIFC Islamic Finance Strategy

Islamic Finance Milestones at DIFC

December 2006	DIFC establishes Islamic Finance Advisory Council to promote the development of Islamic Finance.
July 2006	Islamic International Rating Agency (IIRA), the region's leading Islamic rating agency, established a presence at the DIFC.
March 2007	World's first new Executive MBA specialized in Islamic Finance and Energy delivered in DIFC by Cass Business School
March 2007	DFSA signs MoU with Bank Negara Malaysia in order to facilitate and remove regulatory barriers for Islamic finance transactions between the DIFC and Malaysia.
June 2007	DIFC Investments issues a US$1.25 billion Sukuk, the highest rated and the largest Straight Sukuk to come out of the region.
July 2007	DIFC Investments and Dubai Islamic Bank establish Waqf Trust Services, the First Exclusive Islamic Trust Services Provider in the World offering Sharia compliant trust services.

Growing the Islamic Financial Markets

DIFX is the world's largest exchange for Sukuks with a total value of $16.9 billion, or 40.9% of the value of all listed Sukuks worldwide.



Sukuk Listed on the DIFX

PCFC Development FZCO
US $ 3,500,000,000
Trust certificates Due Á 2008
January 26, 2006

Aabar Sukuk Ltd
US $ 460,000,000
Trust certificates Due 2010
June 30, 2006

TID Global Sukuk Ltd
US $ 150,000,000
Trust certificates Due Á 2011
October 16, 2006

Nakheel Development Ltd
US $ 3,520,000,000
Trust certificates Due Á 2009
December 14, 2006

DIB Sukuk Company Ltd
US $ 750,000,000
Trust certificates Due Á 2012
March 26, 2007

DAAR International Sukuk Ltd
US $ 600,000,000
Trust certificates Due Á 2010
May 28, 2007

IIG Funding Ltd
US $ 200,000,000
Trust certificates Due Á 2012
June 14, 2007

Dubai Sukuk Centre Ltd
US $ 1,250,000,000
Trust certificates Due Á 2012
June 18, 2007

DP World Sukuk Ltd
US $ 1,500,000,000
Trust certificates Due Á 2012
July 3, 2007

Cherating Capital Ltd
US $ 850,000,000
Trust certificates Due Á 2012
July 6, 2007

Dar Al Arkan International Sukuk Ltd
US $ 1,000,000,000
Trust certificates Due Á 2010
July 23, 2007

Ras Al Khaimah Investment Authority
US $ 325,000,000
Trust certificates c Due 2012
December 9, 2007

JAFZ Sukuk Ltd
US $ 2,040,000,000
Trust certificates Due 2012
December 9, 2007

Nakheel Development 2 Ltd
US $ 750,000,000
Trust certificates Due Á 2011
17 January, 2008

Total Sukuk Value of USD 16.9 billion

Collective Investment Law- DIFC Law no. 1 of 2006

- **DFSA issued legislation to regulate managed funds industry within DIFC.**
- **Legislation permits both domicile of funds in DIFC and/or distribution of existing foreign funds (both public & private funds).**
- **Flexible legislation permits variety of recognised investment vehicles.**
- **Regulation of fund operators rather than fund, leaving ample room for product innovation.**
- **Operation of various types of funds including: property funds, Islamic funds, hedge funds, private equity funds, and fund of funds.**
- **Appropriate delegation and outsourcing allowed.**
- **DFSA funds regime in compliance with IOSCO Principles for Collective Investment Schemes.**

DIFC Investment Funds Regime: REITs

The DIFC Investment Trust Law- DIFC Law no. 5 of 2006

- Legislation permitting setting up Collective Investment Funds in the form of an **Investment Trust**.
- Rules to permit the operation of REITS within the DIFC have also been introduced.
- REITS have become the most favoured method for attracting public ownership in property investments.
- They provide a convenient form for listed and tradable property ownership with transparent pricing and liquidity.
- Under these Rules it will be possible to issue REITS for the first time in the region, utilizing the facilities of the DIFX. Innovation for ME's property markets

Concluding Remarks

- Need for government leadership in the process is indispensable.
- Market needs, along with investor demand will drive development of securities by type (whether MBS/ABS, Islamic/conventional, or others).
- Pace and scope of market development are limited only by the institutions & existing regulatory frameworks.

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