2010

The Effect of the Financial Crisis on the Middle East

Isam Salah
King & Spalding

THE EFFECT OF THE FINANCIAL CRISIS ON THE MIDDLE EAST

ISAM SALAH*

I. INTRODUCTION

The Middle East is comprised of a wide geographic area, stretching from Morocco in the northwest corner of Africa to Oman at the tip of the Arabian peninsula in the east, and from Iraq in the north to the Sudan, a portion of which is in sub-Saharan Africa, to the south. The countries that comprise the Middle East are quite different from one another in terms of their economic development, the structure of their economies, and the extent to which they are integrated into the world's economy. Some countries, such as Syria, have relatively closed economies with limited economic interaction with the West and limited inbound or outbound flows of capital. Other countries in the Middle East, in particular the countries of the Gulf Cooperation Council (GCC), are more closely tied to the global economy and their performance is more directly affected by world economic conditions. The countries of the GCC, which are situated opposite Iran along the southern and western sides of the Arabian Gulf, are comprised of Saudi Arabia, the United Arab Emirates (UAE), Oman, Qatar, Bahrain, and Kuwait. The population of these countries ranges from 25 million in Saudi Arabia, the largest country in the GCC, to

* Isam Salah - Partner and Global Head of Middle East & Islamic Finance Practice, King & Spalding, New York and Dubai. B.A. Case Western Reserve University; J.D. Cleveland State University; LL.M. Georgetown University. This article is an edited version of remarks at a symposium on the global financial crisis held at the Cleveland-Marshall College of Law on April 9, 2010.

700,000 in Bahrain, a small island state. These countries have the good fortune of possessing the most significant oil resources in the world. The GCC countries not only derive a substantial portion of their gross domestic product (GDP) through the export of oil and petroleum products, but they also are exporters of capital to other regions of the world and are a destination for capital investment. These countries are not representative of the entire Middle East, but they are the countries that are most frequently discussed and of concern in the West because of their significant oil resources and their strategic location. It is these countries of the GCC on which I am focused.

II. Impact of the World Economic Crisis

The world economic crisis affected countries in the Middle East in much the same way that it affected countries in the West, and the responses of the governments of these countries were generally consistent with the responses of governments in other parts of the developed world. Aggregate real GDP growth of the GCC economies dropped to 0.8% in 2009 from a robust 7.2% in 2008. Inflation in the GCC economies dropped to 2.5% in 2009, from 11.1% in 2008. Banks had liquidity problems, and most GCC countries had housing bubbles that burst. Housing prices dropped by 52% in the Emirate of Dubai, by 35% in Qatar, and by a whopping 62% in Kuwait.

On a country-by-country basis, the drop in real GDP growth was significant in some countries and insignificant in others. Saudi Arabia’s real GDP growth went from just below 5% in 2008 to almost flat in 2009. GDP growth in the United Arab Emirates dropped below zero in 2008, and the same occurred in Kuwait. Qatar, which holds some of the world’s largest natural gas reserves, saw its real GDP growth drop by one-half, from almost 20% in 2008 to just under 10% in 2009. Oman’s real GDP growth fell from 12% in 2008 to approximately 3% in 2009, while Bahrain’s fell from just over 5% in 2008 to almost flat in 2009.

The responses of the governments of the GCC were not especially unique. Like the governments of Western countries, GCC governments sought to make the financial and credit markets more liquid by reducing interest rates and the reserves required to be maintained by financial institutions at their central banks. To avoid a run on deposits at financial institutions, GCC governments guaranteed the repayment of deposits. They also provided financial institutions with dollar swap facilities so that local businesses could satisfy their dollar payment obligations. Governments placed deposits with local banks to provide them with additional liquidity, and they invested in regional stock markets to support share prices. Many of these measures were the same as those measures adopted by Western governments that were experiencing the same problems and risks.

III. Growth of Islamic Finance

One of the distinguishing features of the GCC countries is that an increasing segment of its population has sought for the past three decades to conduct its financial affairs in a manner consistent with principles of Islamic Shari’ah. A number of financial institutions that operate in compliance with the principles of Islamic Shari’ah have been established in this region in response to that demand. In addition, Shari’ah-compliant financing and investment activities have continued to grow in countries outside the GCC region.

Proponents of Islamic finance have regularly claimed that this system of economics is in some respects superior to the conventional economic system because of its avoidance of socially harmful activities, its emphasis on investment in productive assets, and its promotion of equity investment where risk is shared by the parties rather than interest-based lending in which a lender is repaid even if the borrower's enterprise is not successful. These proponents have also claimed that financial institutions and investment firms operating in accordance with Shari'ah principles would be immune to the problems often suffered by conventional, interest-based institutions.

The current financial crisis gives us the opportunity to determine whether there is any merit to this view – whether in fact this growing and increasingly significant segment of the economies of the GCC did respond differently to the world financial crisis. Before beginning this examination, however, we first need to have a basic understanding of the nature of Islamic financial institutions and the manner in which they operate.

IV. NATURE OF ISLAMIC FINANCE

Investing in conformance with Islamic Shari'ah is viewed as a form of socially responsible investing. Financial institutions and companies that operate on a Shari'ah-compliant basis seek to avoid investment in industries that manufacture products, or are engaged in activities, that are viewed as being harmful, such as tobacco, alcohol, casinos, weapons, and products that are religiously proscribed, such as pork. There is an emphasis on equity investment and the sharing of risk. Financing is permitted but it generally must involve a productive asset. The prohibition on the payment or receipt of interest is one of the central distinguishing features of Islamic finance. This prohibition is a common feature of many religions, including Judaism and Christianity, although to a large extent these two religions have dropped this restriction.

Although Islam is a 1,400 year-old religion, modern Islamic finance is a relatively recent phenomenon. It began in the 1960s with the establishment of the first Islamic bank in Egypt. There were a few more Islamic financial institutions established in the 1960s and 1970s, but it was not until the 1980s that Islamic finance in its modern form took off with the establishment of Shari'ah-compliant institutions in the GCC and Malaysia. Today, there are over 200 Islamic financial institutions in the world. These firms operate in accordance with principles of Islamic Shari'ah, and that requirement is generally set out in their charter.

Although Islamic institutions are concentrated in the GCC countries and Malaysia, Islamic finance has become an international phenomenon. Almost every week a new Islamic financial institution or investment company is established in one jurisdiction or another, and the growth of Islamic finance outside the Middle East is generally concentrated in Central and Southeast Asia, and Europe. London, for example, recently licensed its fifth Islamic bank and has proclaimed its desire to be a center for Islamic finance. Although the United States does not have any banks that operate in compliance with Islamic Shari'ah, it does have nineteen organizations, banks included, which offer Shari'ah-compliant products. As an example of the growth of Islamic finance in the United States, the City of Minneapolis recently announced the establishment of a Shari'ah-compliant financing program for Muslim-owned businesses.

These developments are largely driven by market demand. Shari'ah-compliant institutions would not be established or continue to exist if the local population was not interested in these alternative financing mechanisms. Not only does this demand stimulate the establishment of these institutions, but it also justifies the expense necessary to develop Shari'ah-compliant financing and investment products. Moody's, a credit rating agency which performs international financial research and analysis on commercial and government entities, recently estimated that the Islamic finance market has reached $950 billion, and it foresees the market reaching $5 trillion in the near future. Islamic finance has experienced steady growth in GCC countries and today it represents 20% of the GCC market, with the remainder of the market operating on a conventional basis.

A. Role of Shari'ah Scholars

Who decides whether a particular investment or transaction is in compliance with principles of Islamic Shari'ah? Ultimately, it is the market that will accept or reject a product that is claimed to be Shari'ah-compliant, but in making that determination the market will rely on the opinions of scholars who are recognized as being experts in Shari'ah principles and their application. There is currently no central authority for the licensing or certification of these Shari'ah scholars. Nearly every Islamic financial institution, investment company, or fund will have an external board of Shari'ah advisors that will be comprised of recognized scholars, many of whom serve on multiple boards. This advisory board will generally review the operations and significant transactions of the Islamic institution to confirm that they are in compliance with principles of Islamic Shari'ah, and it will then issue a letter to that effect that will be included in the institution's annual report, much like an auditor's letter. In addition, the Shari'ah advisory board will issue a written opinion, known as a fatwa, approving a specific transaction or activity as being in compliance with principles of Islamic Shari'ah.

There are over 200 Shari'ah scholars that have some measure of market recognition. Those scholars that understand modern commercial transactions and are fluent in English are the ones that generally have the greatest international recognition and serve on multiple boards. There are between ten to twenty Shari'ah scholars that fall into this category. It is a unique feature of Islamic finance that the approval of financing and investment transactions, and in particular new structures and products, is controlled by a small group of religious scholars.

Depending on the size or activities of the financial institution or investment company, it may also have on staff one or more employees who have knowledge of Shari'ah principles. These Shari'ah-knowledgeable employees are responsible for looking after day-to-day issues, often in consultation with the external Shari'ah advisory board.

B. Investment and Financing Activities of Islamic Financial Institutions

Guided by the principles of Shari'ah, as interpreted and applied by Shari'ah advisors, Islamic financial institutions have been making various equity investments for their own account and on behalf of their clients for the past two decades and have been providing Shari'ah-compliant financing products to their commercial and retail clients. An understanding of how the world economic crisis impacted Islamic financial institutions requires a basic understanding of the nature of these equity investments and financing products. On equity investments, I would like to focus on real estate investments and Shari'ah-compliant mutual funds. I will also be examining sukuk, which can take the form of an equity investment or a financing transaction depending on the nature of the sukuk. Sukuk are particularly interesting because the difficulties with sukuk arising from the world economic crisis resulted in notable governmental responses.

1. Real Estate Investment

A significant portion of the equity investments made or sponsored by Islamic financial institutions have been in real estate. Property funds of all types have been established, including funds that are region or country specific, such as funds focused on real estate in the U.S., Europe, the Middle East, and Asia, and funds that invest in certain types of real estate.

Investments in real estate are subject to several Shari'ah requirements. First, property cannot be leased to companies that are engaged in business activities that are not in compliance with Shari'ah. This restriction precludes leasing property to commercial tenants that, for example, are interest-based financial institutions, are involved in the manufacture or sale of alcohol or pork products, or whose primary business is in the gaming or movie industry. These restrictions do not apply, however, to the activities of tenants of residential properties. As a result of these restrictions, most of the Shari'ah-compliant property funds are focused on residential apartment complexes, industrial facilities, medical office buildings, and senior living communities.

In addition to these usage restrictions, if acquisition financing is needed, conventional interest-based loans may not be used. Instead, the leverage must be provided using a Shari'ah-compliant structure, such as ijara wa-iqtina, which is a leasing arrangement that is similar to a finance or capital lease, or murabaha, which involves the sale of the property at a price equal to cost plus an agreed-upon profit, with payment of the purchase price to be made in installments over an agreed-upon time period. These financing structures, although clearly tied to an asset, are often indirectly funded by or based on conventional interest-based financing, or they are structured to have the same economic impact.

Islamic financial institutions, acting as equity investment sponsors, arranged a number of property investment funds that invested in real estate in GCC and Western countries, including significant investments in the United States. In keeping with Shari'ah requirements, these investments were in permissible types of properties, and they were typically financed with Shari'ah-complaint structures such as the above-mentioned ijara wa'iqtina and murabaha structures. These financing arrangements were structured to function in a manner very similar, if not identical, to conventional financing structures, and if the investments were made in the United States, these Shari'ah-compliant financing structures generally were treated for tax and accounting purposes in a manner generally the same as conventional, interest-based financing structures.

Because of this similarity, when the world financial crisis hit, these property investments performed as poorly as conventional property investments, if not worse. As vacancies rose in commercial property investments, Shari'ah-compliant investment funds were restricted from leasing property to tenants engaged in impermissible activities. These restrictions reduced the flexibility of the Shari'ah-compliant investment fund owning the property as it limited the number of potential creditworthy tenants, and sometimes also limited the redevelopment opportunities.

In addition, as the property financing obtained by these Shari'ah-compliant investment funds was structured to mimic the economic effect of conventional, interest-based financing, these property investments were subject to the same financial pressures as conventionally financed property investments. As a consequence, from an equity investment standpoint, property investments undertaken by Shari'ah-compliant investment funds performed in a manner comparable to conventional property investments. In the context of the world financial crisis, this meant that a comparable number of these investments went into default and suffered foreclosure, and those investments that avoided such fate experienced a decline in value comparable to the declines experienced by conventional property investment funds. In other words, the view of some proponents of Islamic finance – that it is superior to a conventional, interest-based system – turned out not to be true when it came to property investments that were structured and financed in a manner comparable to conventional property investments.

2. Mutual Funds

Investments in mutual funds have also been prominent, especially when stock markets were booming, and dozens of Shari'ah-compliant mutual funds have been established in the past two decades. These funds have varying investment objectives -- some invest in specific sectors, such as healthcare, while others have a country or regional focus. Some funds invest in private equity or venture capital transactions, and lately several hedge funds that are claimed to be in compliance with Shari'ah have been launched.

Mutual funds typically invest in the shares of publicly-listed companies and, whatever the strategic focus of the mutual fund, those companies in which mutual funds invest need to satisfy the same types of considerations applicable to property investments, meaning they cannot be engaged in impermissible activities. This restriction rules out investments in alcohol and tobacco companies, companies involved in the gambling industry or the production of pork products, interest-based financial institutions, and weapons manufacturers.

The typical Shari'ah-compliant mutual fund will develop a "Shari'ah screen" in cooperation with its Shari'ah advisors or it will adopt one of the recognized Shari'ah screens. The Shari'ah screen will set out the criteria that will be applied to companies to determine whether they are considered to be in compliance with Shari'ah principles. The mutual fund manager may then invest in the shares of companies that are within this universe of Shari'ah-compliant companies.

In addition to screening out companies based on impermissible activities, a Shari'ah screen will also analyze the financial position of a company to determine whether it satisfies financial requirements. The primary purpose of the financial screen is to eliminate those companies that are overly leveraged with conventional debt. Shari'ah scholars have recognized that if investments in companies with any interest-based financing are prohibited, then Islamic mutual funds would not have many companies in which to invest, as almost all public companies have some amount of conventional financing. As a compromise, Shari'ah scholars concluded that it would be permissible to make minority investments in companies that have a moderate level of debt capital, which is generally set at a 1:3 ratio of debt to total assets. Companies that are leveraged beyond that level are impermissible, as is a controlling investment in any such company (unless the investor replaces the conventional financing with forms of Shari'ah-compliant leverage). For our purposes, the key result of the application of these activity and financial tests as part of a Shari'ah screen is that investments in interest-based financial institutions and in companies that are overly leveraged are precluded.

Some of the financial service companies, such as Dow Jones, Thompson Reuters, and FT of London, maintain Shari'ah-compliant indices and license their indices to fund sponsors that want to form mutual funds. These indices will identify on an on-going basis those companies that comply with the applicable Shari'ah screen, adding and removing companies from the permissible companies list as their activities and financial positions change over time. If a mutual fund relies on its own Shari'ah screen rather than license an established index, it will assume responsibility for monitoring the activities and financial position of companies that have previously satisfied its screen.

As we approached 2008, the Islamic financial sector was expanding at a rapid rate and was attracting a growing market, not only in the GCC but in a number of other jurisdictions. Between 2005 and 2008, the number of Shari'ah-compliant mutual funds doubled to more than 500, and it was projected at the time that this number would increase to 700 mutual funds by 2010. On average, their performance leading up to the financial crisis was not materially better or worse than the performance of comparable, conventional mutual funds.

Once the financial crisis hit, however, the performance of Shari'ah-compliant mutual funds did not suffer to the same degree as the performance of conventional mutual funds. Their returns and size did decline during the 2008-09 period as the share prices of companies in their portfolios were battered by the financial crisis, but the declines they experienced were less severe than the declines suffered by comparable, conventional mutual funds. For example, Standard & Poor's in 2008 observed that in the Middle East and North Africa region, Shari'ah-compliant mutual funds "outperformed" similar conventional funds because the losses they suffered were not as severe, dropping by 29% in comparison with a 34% drop in the S&P index.

Market commentators were quick to point out that the observance of Shari'ah principles was resulting in the superior performance that had been predicted. The underlying reasons for this better performance were quite obvious, however. Financial institution stocks were among those that were the most severely affected by the financial crisis, so the prohibition on investment in those stocks served Islamic mutual funds quite well. In addition, as the financial crisis also resulted in a contraction of the credit markets, companies that were heavily leveraged were negatively affected. The Shari'ah screens had the beneficial effect of steering Islamic mutual funds away from those overly-leveraged companies.

This superior performance of Islamic mutual funds was short-lived. As the stock market began to recover, those stocks that led the way were financial institution stocks. Although Islamic mutual funds avoided the pain of holding financial institution stocks when the crisis hit, they also missed out on the gains that were recorded by financial institution stocks as stock markets began to recover.

Looking at property investments complying with principles of Islamic Shari'ah, we saw that their performance was no better and no worse than conventional property investments. As property markets declined, they brought down both conventional and Shari'ah-compliant property investments. If a Shari'ah-compliant property investment utilized leverage, that investment was as affected by adverse property market conditions as a conventional property investment financed with conventional leverage. The fact that an investment had its leverage structured on a Shari'ah-compliant basis did not mitigate the effects of the financial crisis. A Shari'ah-compliant property investment could be foreclosed with no materially greater effort than a conventionally-financed property investment.

3. Rise and Fall of Sukuk

You may have heard of the financing and investment instruments known as sukuk. Sukuk came to prominence several years ago when Dubai World, a commercial enterprise wholly-owned by the Emirate of Dubai, sought to acquire the port operation business of P&O, a large port operator. This potential acquisition generated significant controversy in the United States because several of the P&O ports to be taken over were located in the United States, and there was an uproar in Congress over foreign control of U.S. ports. That acquisition was eventually completed and it was financed with a $2.8 billion offering of sukuk, which at the time was a particularly unique way of financing a major transaction of this type.

Sukuk instruments generally represent an interest in an underlying, Shari'ah-compliant transaction. If the underlying transaction has the characteristics of a financing, such as a lease (ijara) transaction, then the sukuk that are issued (which essentially grant an indirect interest in the underlying transaction) will be treated as a debt instruments. If the underlying transaction has the characteristics of an equity investment, then the corresponding sukuk will be treated as equity instruments. Most of the sukuk that have been issued are treated as debt instruments. Sukuk have received an inordinate amount of attention in Islamic finance circles because they are capital markets transactions (which generally have a higher profile) and because they are viewed as being important to the development of an Islamic capital market.

Sukuk offerings have grown significantly in importance and size since its first offering - a sovereign issuance by Malaysia in 2002. Most sukuk offerings take place in the GCC and Malaysia, with a significant number of offerings being undertaken by sovereigns or state enterprises. Recent sukuk issuances include a large offering by the government of Indonesia. GE Capital also recently financed a commercial aircraft with a sukuk offering out of the U.S., the second one done in the U.S. in the last five years. The United Kingdom and France have discussed the possibility of sovereign issuances and have begun to look at the legislative changes that might be necessary to permit such issuances.

In 2007, five years after the first Malaysian offering, sukuk issuances reached $25 billion, and indications were that this fast-paced growth would continue. In 2008, however, sukuk offerings dropped to $16 billion, and were nominal in 2009. We have witnessed a resumption of sukuk issuances in 2010, and indications are that this trend will continue.

4. Sukuk Defaults

As the world economic crisis hit the Middle East in 2008-09, we witnessed a number of defaults and near defaults affecting sukuk issuances. One situation that received significant attention, both because of its size and the involvement (as investors) of Western financial institutions, was the potential default of Nakheel, a significant subsidiary of Dubai World. Nakheel is the real estate company that developed the striking Palm Islands off the coast of Dubai, one of several high-profile real estate developments that it undertook. Nakheel financed its development activities with both conventional debt and Shari'ah-compliant financing, including a large offering of sukuk.

In December 2009, with a significant payment coming due on sukuk issued by Nakheel, Dubai World announced that it would be seeking to have the creditors of Nakheel enter into a standstill agreement to allow Nakheel time to develop a plan to deal with all of its creditors, including the holders of the subject sukuk, in an orderly and consistent manner. This announcement brought the financial crisis in Dubai to a head. Up to this time, creditors of Dubai World and its subsidiaries had assumed that the government of Dubai implicitly guaranteed the obligations of Dubai World and other Dubai state enterprises, notwithstanding documentation that explicitly disclaimed any such guarantee. Those creditors, many of which were Western financial institutions, simply believed that the disclaimers were a legal nicety and that the government of Dubai would never let its state enterprises default on their financial obligations. They were surprised to find that their beliefs might not be well founded, and this discovery sent shock waves through the financial community.

As many financial institution investors were relying on the backing of the government of Dubai, their attention to the structures of the sukuk they were purchasing and the terms of the documentation was perhaps not as thorough as it should have been. Their response to the announcement of the government of Dubai that it would not be guaranteeing the payment obligations of Nakheel was to instruct their legal counsel to review the sukuk documentation to better understand their legal rights and remedies. Often this analysis pitted sukuk holders against other creditors (conventional and Shari'ah-compliant), all of whom were trying to determine who had superior rights to the assets of Nakheel. This realization that their rights to assets and collateral was less than clear was followed by a further realization that the bankruptcy laws in the UAE (and in other jurisdictions where similar defaults were taking place) were quite inadequate to deal with this type of potentially complicated default and bankruptcy. Creditors and their counsel soon came to appreciate that the bankruptcy laws that existed in many GCC countries, including the UAE, were primarily liquidation laws that governed how assets of a bankrupt company would be liquidated and distributed, rather than restructuring laws that are intended to permit a financially ailing company to restructure its financial obligations so that it can continue in business. When payment on the Nakheel sukuk eventually came due, the Emirate of Abu Dhabi stepped in to provide financing to Dubai, thereby enabling Nakheel to make its payment on time.

V. Regulatory Response and Reform

Although this payment relieved the immediate crisis, the more significant development was Dubai's issuance of Decree No. 57, which constituted a recognition that the existing insolvency laws in Dubai and the UAE were inadequate to deal with a large and complex restructuring of a domestic company. The centerpiece of Decree No. 57 was the application of the insolvency law of the Dubai International Financial Centre (DIFC), which is a financial free-zone in Dubai, to Dubai World and its subsidiaries. The insolvency law of the DIFC is based on the insolvency law of the United Kingdom, with some Australian and American features, and thus is designed to deal not only with the process of liquidating a company, but also the process of restructuring the ownership and finances of a company so that it can continue in operation. The Decree created a special tribunal that would hear all insolvency proceedings relating to Dubai World and it subsidiaries, and it stripped the UAE courts of their authority to deal with insolvencies. The tribunal, which was staffed initially with Singaporean and U.K. judges, was given wide powers, including the power of an "automatic stay" on the exercise of creditor's rights. The Decree also provided a "cram down" mechanism and contained provisions that would allow debtor-in-possession financing, features that did not exist with the existing law. From a legislative standpoint, one can consider the introduction of a reformed and contemporary insolvency law in Dubai as being one notable reaction (or consequence) arising from the impact of the world economic crisis in the Middle East.

VI. CONCLUSION

The impact of the world economic crisis on the Middle East, and in particular on the countries of the GCC, was similar to the impact elsewhere in the West – collapse of the real estate sector, credit constraints, and economic contraction. The reaction of governments of the GCC was similar to the reaction of governments in the West – support of financial institutions and provisions of liquidity to the financial markets.

Islamic finance has established itself as an important component of the commercial and financial sectors in these countries, so it is interesting to examine whether this segment of the market performed better or differently than the conventional segment. Even though its promoters have claimed that Shari'ah-compliant investments would fare better in a financial crisis than conventionally structured and financed investments, there were in fact more similarities than differences in performance. Finally, when problems arose, it became clear that the legal systems in some of these countries were not adequate to deal with the restructuring of struggling companies, and as a consequence, insolvency laws were being examined in a number of jurisdictions, and the Emirate of Dubai introduced a decree that had the effect of imposing a more contemporary insolvency regime on its key state enterprise.