The Importance of International Standards in Managing Defaults in Islamic Finance: Saudi Arabia and the Saad Group's *Sukuk* Default

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May 2013

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Executive Summary

- Issuances of financial instruments that comply with Sharia law, including its bar on interest payments, have grown from $7 billion in 2005 to $140 billion in 2012.

- The 2009 failure of two Saudi conglomerates, the Saad Group and the Algosaibi Group, with outstanding debt obligations of some $20 billion, has raised concerns about the Saudi process for resolving the claims of foreign creditors in accordance with international standards and best practices.

- Outside Saudi Arabia, some of these concerns have focused on the default by the Saad Group of the $650 million "Golden Belt" *sukuk,* an Islamic corporate debt instrument, and the lawful claims of foreign financial institutions that held the instrument. The Saudi Government's management of this default and those claims has violated World Bank and IMF standards and best practices for transparency and equal treatment of all creditors.

- Soon after the Saad Group default, the Saudi Government created a special committee that resolved much of the debt owed to Saudi financial institutions, but not Saad Group debt held by foreign institutions, such as Golden Belt. The Saudis have not established a similar process for foreign creditors or provided them certain information vital to their claims.

- This reluctance to provide transparency and equitable treatment for foreign holders of the Golden Belt *sukuk* contrasts sharply with the behavior of other Islamic governments, including Malaysia, Kuwait and the UAE, which have handled restructurings of Islamic financial instruments in accordance with international standards and best practices.

- The Saudis also have not facilitated Golden Belt's investors' access to assets held by the *sukuk*'s sponsor or their ability to enforce a promissory note which the Saad Group's owner provided those investors.

- The Saudi's mishandling of the Golden Belt default is reflected in the World Bank's evaluations of the country's legal system and administration: Saudi Arabia ranks 107th of 185 nations in "resolving insolvencies" and 124th in the world for "enforcing contracts."

- The Saudi's poor performance in these critical areas is likely damaging their economic prospects: Since the 2009 defaults, foreign direct investment into Saudi Arabia has fallen almost 50 percent, while increasing in other Islamic nations such as UAE and Malaysia.

A recent OECD study ranked Saudi Arabia 20th out of 44 Islamic countries for inward FDI performance.

- Saudi Arabia can become an important locale for Islamic finance, on the model of Malaysia, only if it reforms its institutions and practices to ensure that all creditors enjoy transparency and equal rights in cross-border insolvencies.

Introduction

In June 2009, amidst the fallout from the global financial crisis, Saudi Arabia experienced its largest financial defaults in history when two prominent, family-owned conglomerates, the Saad Group and the Algosaibi Group, were forced to restructure an estimated $20 billion in debts owed to more than 100 financial institutions around the world. Some of those debts were s*ukuk,* financial instruments comparable to corporate bonds but structured to comply with the Sharia law. Instead of earning interest, investors in *sukuk* receive designated returns derived from real assets held by the entity issuing the *sukuk*. The mismanagement of these defaults and restructurings by the Saudi Government, especially regarding foreign holders of Saad and Algosaibi debt, raises serious questions about Saudi Arabia's capacity to oversee operations in Islamic finance. If global investors determine that the Saudi Government cannot protect the rights of foreign creditors in accordance with international standards and best practices, financial flows and foreign direct investments into Saudi Arabia will decline, setting back Saudi plans to modernize their economy.

Much of the criticism of the Saudi performance in these defaults has focused on issues of transparency and equal treatment for foreign creditors. Many aspects of the operations of the Saad and Algosaibi Groups that affect the defaults remain shrouded in secrecy and unavailable to foreign creditors, and the Saudi Government appears to have abetted this lack of transparency. The Saudi Government also appears to have actively promoted preferential treatment for Saudi investors. The Government created a Royal Commission or "special committee" to restructure much of the Saad Group debt owed to Saudi lenders, while ignoring foreign creditors. This apparent bias and absence of transparency violate international standards for cross-border insolvencies set out by the World Bank and International Monetary Fund (IMF).

These continuing breaches of international standards and norms for cross-border insolvencies are part of a larger pattern of behavior which has cast doubts on Saudi Arabia's capacity to protect foreign investors and become a attractive locale for Islamic finance. The World Bank calls the Saudi administration of insolvencies "underdeveloped" and criticized its administrators as neither "competent and effective" nor "adequately supervised or accountable." These administrators and senior Saudi officials have been unforthcoming regarding the requirements, procedures and standards for resolving claims by foreign lenders. Continued failure to resolve their claims in the recent defaults will damage Saudi Arabia's reputation with foreign banks and other investors. Saudi authorities should reform their country's legal and

regulatory institutions to protect foreign as well as domestic creditor rights and ensure proper treatment in cross-border insolvency cases based on international standards. These steps would improve the Saudi business climate and promote foreign investment and growth.

The Market for *Sukuk*

In a typical *sukuk* transaction, a sponsor such as the Saad Group creates a special purpose vehicle (SPV) entity which solicits funds from investors for the purchase of property or other assets, which the SPV leases back to the sponsor to generate regular payments for the investors. When the *sukuk* matures, the SPV sells the property or other assets to the sponsor and distributes the proceeds to the investors. The market for these instruments has grown rapidly over the last decade, from worldwide issuances of $7 billion in 2005 to $140 billion in 2012. Malaysia is the largest center of this Islamic finance, but Saudi Arabia and other countries also are trying to tap the worldwide demand by Islamic banks for Sharia-compliant products. This demand is so strong that according to estimates by Credit Agricole, spreads on *sukuk* average 20 basis points less than the yields on comparable corporate bonds.

The first known *sukuk* default occurred in May 2009 when the Kuwait-based Investment Dar missed a $100 million payment on an Islamic bond. The largest *sukuk* default occurred in November 2009 with the Saad Group's default on the $650 million Golden Belt *sukuk*. Golden Belt was issued in May 2007 with a contractual maturity of May 2012 and sold to foreign financial institutions by Saad Trading and Contracting. To assure creditors of the instrument's safety, note holders received a promissory note for the full $650 million personally guaranteed by the Saad Group's head, Mr. Maan Al-Sanea. Like other *sukuk*, Golden Belt was issued by a SPV, which used the proceeds to purchase properties in Saudi Arabia that were leased back to the Saad Group. The Saad Group's semi-annual lease payments to the SPV were distributed to the investors in lieu of interest payments. Since the default, the Saad Group and the Saudi Government have taken few steps to restructure Golden Belt for its foreign creditors.

Saudi Arabia's refusal to protect the rights of foreign lenders, as it has for domestic lenders, and thereby resolve the default contrasts sharply with actions by other Islamic governments. The United Arab Emirates, for example, created a bailout package to pay some $3.4 billion in maturing debt from the Nakheel *sukuk* defaults, and Malaysia and Kuwait have addressed defaults of Islamic financial instruments in their countries through normal legal processes that meet international standards.

The Saad Group and Algosaibi Group Defaults

As noted, the default of the Golden Belt *sukuk* is part of the financial difficulties which overtook the Saad Group and the Algosaibi Group. These difficulties began in May and June of 2009, when the International Banking Corporation (TIBC) failed to meet payments on loans from other banks, and Standard and Poor's (S&P) downgraded TIBC's rating to "selective default." S&P revealed that TIBC's parent company, the Algosaibi Group, was planning a Group-wide debt restructuring, and also downgraded the outlook of the Saad Group, citing its close ties to TIBC. Saudi Arabia's Central Bank, the Saudi Arabian Monetary Agency (SAMA),

froze the accounts of the Saad Group's owner, Mr. Al-Sanea; and the next day, he announced that the Saad Group would undertake an "orderly restructuring" of its debts. Working with Credit Suisse, Mr. Al-Sanea pledged to work with "international, regional, and domestic counterparties to assure *pari passu* treatment" [treating all creditors equally]. Moody's Investor Services downgraded the debts of the Saad Group and its subsidiaries to "junk" status; and Standard and Poor's downgraded the Group to default status. Both rating agencies subsequently withdrew all credit ratings for the Saad Group, citing lack of adequate information.

Following news of the crisis facing the Saad and Algosaibi Groups, financial institutions around the world reassessed their exposure to the two conglomerates. The debts owed by the two Groups were estimated at between $15 billion to $22 billion, with most analysts settling on $20 billion. The Algosaibi Group is thought to be responsible for an estimated $9.2 billion of this debt, and the Saad Group owes between $6 billion and $13 billion. Estimates by HSBC, Standard Chartered, and S&P (based on a survey of banks in the Gulf Cooperation Council) suggest that institutions outside the Gulf have an exposure of at least $6 billion, including Golden Belt.

Saudi Government Involvement

In September 2009, the Saudi government created a Royal Commission or "special committee" to facilitate the debt restructurings of the two Groups. Within weeks, the special committee brokered a deal between the Saad Group and many of its local Saudi creditors, including seven Saudi banks which received $2.6 billion in repayments (a 15 percent haircut). The committee, however, refused to address the claims of any foreign creditors, despite protests that discriminating between local and international banks would slow the restructuring process, damage Saudi Arabia's reputation, and discourage future lending by foreign investors. The British Bankers' Association (BBA), for example, expressed its concerns that the Saudi Government's favoritism would damage Saudi Arabia's reputation for fair dealing and hamper the ability of Saudi firms to borrow in international markets. Representatives from other Gulf governments including the UAE, Oman, and Bahrain also reportedly expressed frustration with a deal which excluded creditors from their own countries. The Saudi Central Bank, which was not involved in the negotiations, also reportedly opposed the terms of the deal.

In addition to their exclusion from the prompt restructurings overseen by the Government's special committee, foreign investors have faced other obstacles. The foreign investors who hold the Golden Belt *sukuk* have been unable to either execute the personal promissory note provided to them by the owner of the Saad Group when the *sukuk* was issued or gain any access to the physical assets held by the SPV which issued the Golden Belt note.

International Norms and Best Practices in Managing Cross-Border Insolvencies

These actions by the Saudi Government violate the standards and best practices of international finance in a number of ways. To begin, a central principle of international insolvency law holds that all aspects of the process should be transparent to creditors. In 1999, the IMF published "Orderly and Effective Insolvency Procedures Key Issues," which states that one of the objectives of insolvency law is to ensure that market risk is allocated in a "predictable

and transparent" manner. Transparency is a general issue with Saudi governance, with the U.S. State Department concluding that "there are few aspects of the [Saudi Government's] regulatory system that are transparent."

Another principle of international insolvency law holds that all creditors must be treated equitably, regardless of nationality or residence. This principle is articulated in numerous declarations by international organizations. In 1997, the United Nations Commission on International Trade Law, for example, published its "Model Law on Cross-Border Insolvency." Article 13 of the Model Law notes the importance of nondiscrimination with respect to treatment of foreign claims: "Foreign creditors have the same rights regarding the commencement of, and participation in, a proceeding under [State insolvency laws] as creditors in this State." Similarly, the IMF findings on key issues in insolvency also hold that insolvency law and proceedings should ensure equitable treatment of investors. Such equal treatment, the IMF notes, strengthens confidence in the credit system and fosters economic growth:

> "For the benefit of all creditors, however, an insolvency law must address the problem of fraud and favoritism that often arises in the context of financial distress. Moreover, given the importance of international credit and investment, the law must ensure that there is no discrimination against foreign creditors. Finally, the collective nature of a proceeding can give reassurance to creditors that problems will be resolved in an orderly and equitable manner."

The World Bank's "Principles and Guidelines for Effective Insolvency and Creditor Rights Systems" (2000) also describes international best practices for corporate insolvencies. The Bank held that every nation must establish a framework for cross-border insolvencies that will "provide for equitable treatment of similarly situated creditors, including similarly situated foreign and domestic creditors." Equitable treatment of all creditors, the Bank holds, builds investor confidence and ultimately promotes financial system stability.

The Adverse Effects of Ignoring These International Standards and Best Practices

Ignoring or rejecting international standards and best practices in managing cross-border defaults can have important economic implications. Empirical analysis has shown that the legal institutions and regulations which help shape a country's business climate have direct effects on that country's overall economy. In particular, studies have found that countries which protect foreign and domestic investors by ensuring creditor rights and enforcing their contracts attract higher levels of investment, which in turn leads to stronger economic growth.

The World Bank's annual *Doing Business* report provides a series of indicators to evaluate countries on their legal systems and regulations. In the 2013 *Doing Business* report, the World Bank ranked Saudi Arabia 22nd for general ease of doing business there, including high scores on formal investor protections. Yet, the Bank also found that an investor's ability to call on those protections is relatively weak. On a 10-point scale measuring the strength of the country's legal rights, Saudi Arabia scored 5. The World Bank further noted that the Kingdom's collateral and bankruptcy laws in particular do not effectively protect the rights of borrowers and

lenders.

Most important for the issues examined here, the 2013 report also ranks Saudi Arabia 124th out of 185 nations for "enforcing contracts," an essential issue in the handling of the Golden Belt *sukuk* and other debts arising from the defaults by the Saad and Algosaibi Groups. Furthermore, the World Bank report ranks Saudi Arabia 107th in the world for "resolving insolvencies."

Once again, the Saudi handling of the Golden Belt *sukuk* provides clear evidence for these poor ratings. A normal process might give its creditors access to the physical assets held by the SPV that issued the *sukuk*, or alternatively execute the personal promissory note for the entire amount provided by the owner of the Saad Group to Golden Belt's investors. Neither has occurred.

There is also evidence that the Saudi administration of the defaults is dampening foreign investment in the Saudi economy. Even before the Golden Belt and other defaults affecting foreign investors, an OECD study ranked Saudi Arabia 20th out of 45 Muslim countries for inward FDI performance. Since 2009, when the defaults occurred, FDI flows into Saudi Arabia have fallen by almost 50 percent while FDI in other Gulf nations such as the United Arab Emirates has increased. By 2011, Saudi Arabia lagged Lebanon, Jordan, Djibouti and Iraq in the region for inward foreign direct investment as a share of GDP.

Conclusions

The Saad and Algosaibi Group defaults and the Saudi Government's improper steps in aggressively restructuring debt instruments for local Saudi institutions but not *sukuk* and other debts owed to foreign investors, represent a disturbing precedent for how the country treats foreign investors in cases of cross-border insolvencies. The Saudi Government should reform its institutions and practices in ways which explicitly and effectively ensure transparency throughout the insolvency process and protect equally all creditors' rights in cross-border insolvencies. Without these reforms, Saudi Arabia is likely to see foreign investor confidence erode further, which in time will slow the modernization of its economy and impair its long-term growth.

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