Alternative Financing Arrangements in the United Arab Emirates and Saudi Arabia

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Historically, local banks have provided the vast majority of financings to borrowers in the United Arab Emirates (the UAE) and Saudi Arabia across all asset classes. However, the banking landscape has dramatically changed over the past decade or so — where the level of bank debt which is actually available has significantly dropped. This has in turn resulted in the growth (or at least the need for the growth) of alternative financing arrangements – both in terms of regional managers establishing credit funds and international funds targeting transactions in the UAE and Saudi Arabia.

We believe that alternative financing as a substitute for commercial bank lending in the countries of the Cooperation Council for the Arab States of the Gulf (the GCC), in particular in the UAE and Saudi Arabia, is on the rise and pivotal to the growth of the economy, benefiting both lenders and borrowers alike. In this article we explore trends in this space in the UAE and Saudi Arabia including legal and practical considerations.

What is Alternative Finance?

Alternative finance can be defined by reference to the following key features of such financing arrangements:

a) First, alternative finance is provided by non-bank lenders. Bank lenders are typically considered to be highly regulated, which in turn allows such lenders to accept deposits from consumers, and deal with consumers and engage in a broad range of financial activities.

   Alternative finance providers on the other hand generally comprise financial institutions, companies and/or funds which are not considered full-scale banks by virtue of the fact that such participants do not offer both lending and deposit taking services. Such participants include institutional investors, such as pension funds and insurance companies, as well as investment funds with various strategies such as mezzanine-funds, credit funds and real estate funds.

b) Secondly, providers of alternative finance tend to offer more flexibility in terms of both financing terms and structures that differ to traditional bank lending structures. For instance, a mezzanine debt fund may be able to take limited security, but it would in turn expect higher returns.

Growth of Alternative Finance in the GCC

In the GCC, bank lending continues to constitute the bulk of financings. However, in the recent years the market has witnessed an increased desire to move away from traditional bank lending structures. There are a number of reasons for this phenomenon including:

a) Increase in the regulatory requirements:

Following the global financial crisis and the increase in regulatory requirements applicable to banks, it is fair to say that the overall banking volumes have fallen below the pre-crisis levels. The increase in regulation

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b) **Certain sectors have suffered more than others from bank retrenchment:**

Although certain sectors and borrowers continue to see a healthy degree of liquidity, others have experienced significant tightening of credit. Examples of such sectors and borrowers include:

i. **SMEs:** Small and medium-sized enterprises (SMEs) comprise 94% of the companies operating in the UAE, contributing to 60% of the UAE's GDP. Yet SMEs continue to find it tougher than ever to access finance, in particular from banking institutions. Data provided by the Khalifa Fund for Enterprise Development shows that approximately 50-70% of the SME applications for funding are rejected by conventional banks in the UAE. Loans to SMEs account for just 4% of the outstanding bank credit in the UAE.

In Saudi Arabia, growth of SMEs is a key goal of the country's Vision 2030 with a plan to increase SMEs' contribution to Saudi Arabia's GDP from 20% to 35% by 2030. The country has introduced a number of initiatives (such as the Kafalah Program which guarantees bank debt for SMEs) to spur financing and growth in the SME space. While such initiatives have been successful, there still remains inadequate funding for SMEs in the country.

SMEs at large are not in a position to meet the requirements of commercial bank lenders such as the common request to provide a history of profit for a minimum number of years or high-quality collateral as security.

ii. **Private equity transactions and leverage buy outs:** Although we have seen a continued growth in private equity transactions in the GCC, it is apparent that the private equity industry has faced challenging times in terms of bank financings in the recent years. Some of the challenges have resulted from banks not being in a position to offer commercially competitive terms (including requesting security which is not viable from the borrowers' perspective). This is in contrast to the European leverage market, where debt is cheap with financing terms being loose and light. This is certainly a key area which can benefit from alternative finance filling in the void left by bank lending.

iii. **Real estate transactions:** Arguably given the proximity between real estate and the 2008 financial crisis, we have seen more of a reduction in commercial bank lending to the real estate sector compared to any other sectors – particularly in respect of construction and development financing. Aside from the liquidity gap, the real estate sector offers attractive characteristics to the alternative finance providers (e.g. stability and returns).

In the GCC there also has been a strong need for "last mile financing" to allow the completion of partially constructed projects. Generally, these types of projects already have senior debt and any new bank lender will want to negotiate an intercreditor arrangement. Alternative credit financiers and funds potentially can be more flexible with their structures and risk profiles.

In summary, the "liquidity gap" has led borrowers to seek out alternative funding sources, both in terms of products and types of lenders.

Recent Regulatory Changes

Certain regulatory changes which have been recently introduced in the UAE and Saudi Arabia have given greater comfort to alternative credit providers, including:

a) **The introduction and the development of insolvency regimes.** A statutory insolvency and bankruptcy regime was introduced in the UAE in 2016 with the adoption of Federal Law No. 9 of 2016 on Bankruptcy. Saudi Arabia followed suit by enacting its Bankruptcy Law more recently in August 2018. In both countries, the authorities sought to provide clarity to both lenders and borrowers with the aim to protect creditors' rights, while allowing borrowers to reorganize their financial affairs and encouraging them to fulfill their contractual obligations.

b) **The introduction of new security laws.** In the UAE, Federal Law No. 20 of 2016 on Mortgaging Movable Property as Surety for Debt was introduced, which allows non-UAE licensed banks to take security over certain specified assets. In Saudi Arabia, the Commercial Pledge Law was issued in April 2018 and the regulations establishing the Unified Register for Commercial Pledges were issued in March 2019. The introduction of these regulations will allow for parties to engage in secured lending transactions in Saudi Arabia to perfect security interests.

c) **The introduction of Saudi Arabian financing funds.** The Saudi Arabian Capital Market Authority (the CMA) and Saudi Arabian Monetary Authority (SAMA) recently issued a circular allowing CMA-regulated asset managers to tie up with SAMA-regulated financing companies. In January 2019, the first such fund was established by Saudi Kuwait Finance House, which will invest in the lending business of Al Yusr Leasing and Financing Company through a Shari'ah-compliant financing arrangement.

Separately, it is expected that the CMA and SAMA will introduce regulations allowing for direct lending funds this year. In particular, managers are eager to establish SME financing funds and real estate mortgage and financing funds to fill needs in the market.

Key Considerations

Managers and other financial institutions looking to enter the alternative credit market in the UAE and Saudi Arabia will find a market that requires a large amount of capital, but that also does not have a stringent set of regulations governing the provision of alternative credit. Key considerations include:

a) **Difficult fundraising environment for funds deploying capital in the GCC.** For the past 12-18 months, managers establishing or marketing funds in the region have had difficulty raising target commitments. The primary exception has been credit funds where returns have been higher than many other income-generating funds investing in other asset classes and are widely viewed as relatively safe investments. Most investors in the region have placed a priority on steady income and credit funds have provided this. The majority of the credit funds being sold in the region are investing into more established markets, such as the US or Europe, but this is partially driven by the lack of local funds in this asset class.

b) **Regulatory Considerations.** In both Saudi Arabia and the UAE, there are very few laws specifically governing the provision of alternative finance. While there are a number of active participants in the market, it is to some extent unclear what licensing regime would be imposed to locally domiciled credit funds by the UAE Central Bank (which regulates financing activities in the UAE), the UAE Securities and Commodities Authority (SCA) (which regulates the asset management industry in the UAE), SAMA (which regulates financing activities in Saudi Arabia) and/or the CMA (which regulates the asset management industry in Saudi Arabia). The legislation and practices are evolving and we expect substantial developments in this space in both jurisdictions, particularly in relation to cross-border financings.

c) **Shari'ah Considerations.** In Saudi Arabia and to a lesser extent the UAE, borrowers may be seeking financing on a Shari'ah compliant basis. This will require the understanding and implementation of Shari'ah compliant financing structures, including murabaha transactions. We are seeing a number of traditionally conventional institutions enter this space – including mezzanine and credit funds from Asia and Europe.

Conclusion

A number of factors have collectively created an active market for alternative credit in the UAE and Saudi Arabia. We expect the the legal and regulatory framework to continue to evolve in this area. In the meantime, financial institutions looking to provide alternative credit in the UAE and Saudi Arabia will find a plethora of willing borrowers to lend to as well as an interested investor base to provide capital to their fund vehicles.

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