

Debt Crisis in Dubai: Whither the 'Islamic Financial Alternative'?



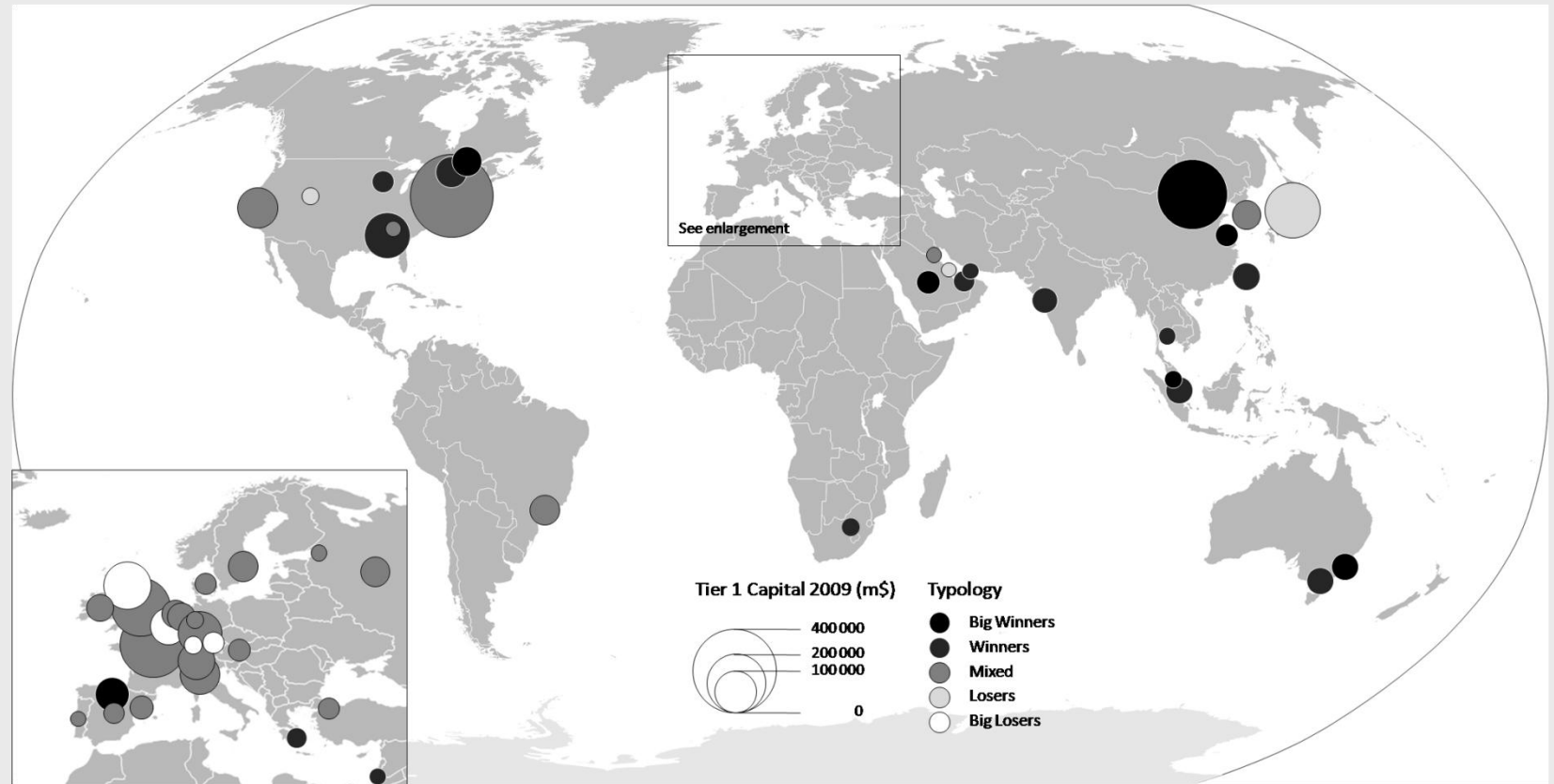
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Traditional Values, Progressive Spirit

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Objective:

1. To discuss some of the major **geographical** and **qualitative** shifts in the global financial system, which seem to have been reinforced by the global financial crisis.
2. Instead of focusing on 'mainstream' financial circuits, anchored in major IFCs (e.g. London, New York), we discuss the **Islamic financial services** (IFS) sector, which is gaining ground in the **Gulf region and Malaysia, but also in North America and Europe.**
3. We look how this 'parallel' or 'alternative' market is in fact heavily interrelated with and **produced by actors in 'traditional' IFCs** (especially London) and **'emerging' IFCs** (Dubai, Abu Dhabi, Kuala Lumpur) in their quest for profits, products, investors etc . Focus on **sukuk issuance proces.**
4. To discuss the prospects for IFS in light of **Dubai's recent debt crisis**

1. A 'reOrientation' of the global financial system:



Typology of IFCs during the current financial turmoil (Derudder et al., Area, forthcoming)

1. A 'reOrientation' of the global financial system?

The crisis has had a **variegated spatial impact** on the global financial system and its articulation in IFCs:

- **'Traditional' IFCs** in Europe, North America and Japan have been hit the hardest by the crisis. **Chinese cities** (most notably Beijing, Shanghai) are booming, while **Gulf Cities** are doing well as emerging hubs in between.
- **"Capital is flowing uphill"**: Gulf investments by **private, corporate** and **sovereign investors (SWFs)** in 'core' regions of the world economy (Europe, Northern America): financial sector (Citigroup, Barclays, etc.), US treasury bills, etc.

The global financial system is experiencing **qualitative** changes:

- **Emerging 'alternative' forms of capital mediation/accumulation such as the Islamic Financial Services (IFS) sector, which is growing rapidly in Gulf cities/IFCs**

2. Gulf IFCs as Islamic finance nodes

- Key instrumental features are the prohibition of:
 - *riba*: 'growth', generally interpreted as all forms of **interest**
 - *gharar*: **uncertainty** in contracts, legal risk
 - *maysir*: 'gambling', **unnecessary risk taking**, no speculation
 - investment in weaponry, pork meat, pornography, and alcohol is ***haram***.
- As a result Islamic economics is **opposed to conventional debt-trading** and promotes a system of **equity** investment.
- Focus is on the real economy: Products and trade should ideally be **asset-based**, i.e. involve an underlying asset.
- Loans or investments are ideally based on **profit-and-loss sharing (PLS)** : pre-agreed part of the profits or loss by ratio of the investment

2. Gulf IFCs as Islamic finance nodes

- From the 1970s, an **enormous capital accumulation** in the oil-producing countries, following the **oil crisis** of 1973, and in subsequent periods with high oil prices (e.g. 2008), provided the capital base for the IFS sector:



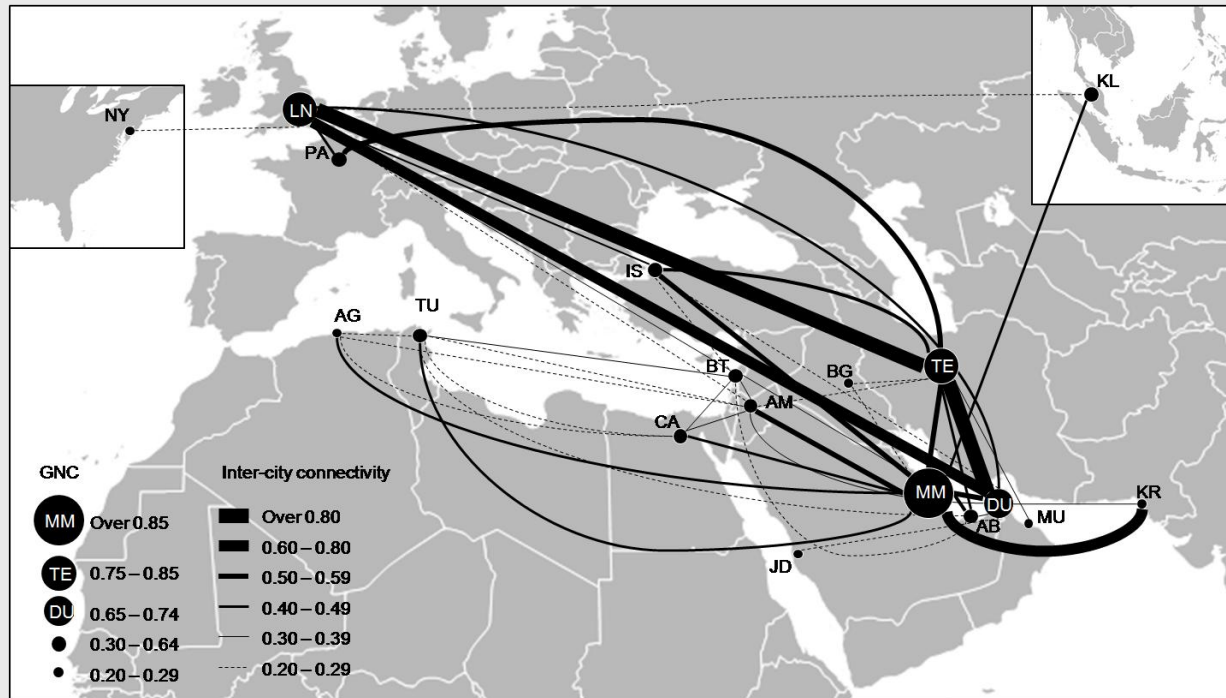
→ 1975: **Islamic Development Bank** part of organization of the Islamic Conference

→ first full-fledged **commercial retail and investment banks**: Dubai Islamic Bank (°1975), Bahrain Islamic Bank (°1979)

- 'Conventional' banks have Shari'a-compliant **Islamic windows** as separate entities within the organizational structure (e.g. HSBC Amanah).
- The sector now has an estimated worth of **US\$ 822 billion** (The Banker, 2009), of which ca. 40% is located in the Gulf Region

3. Globalization of the IFS sector

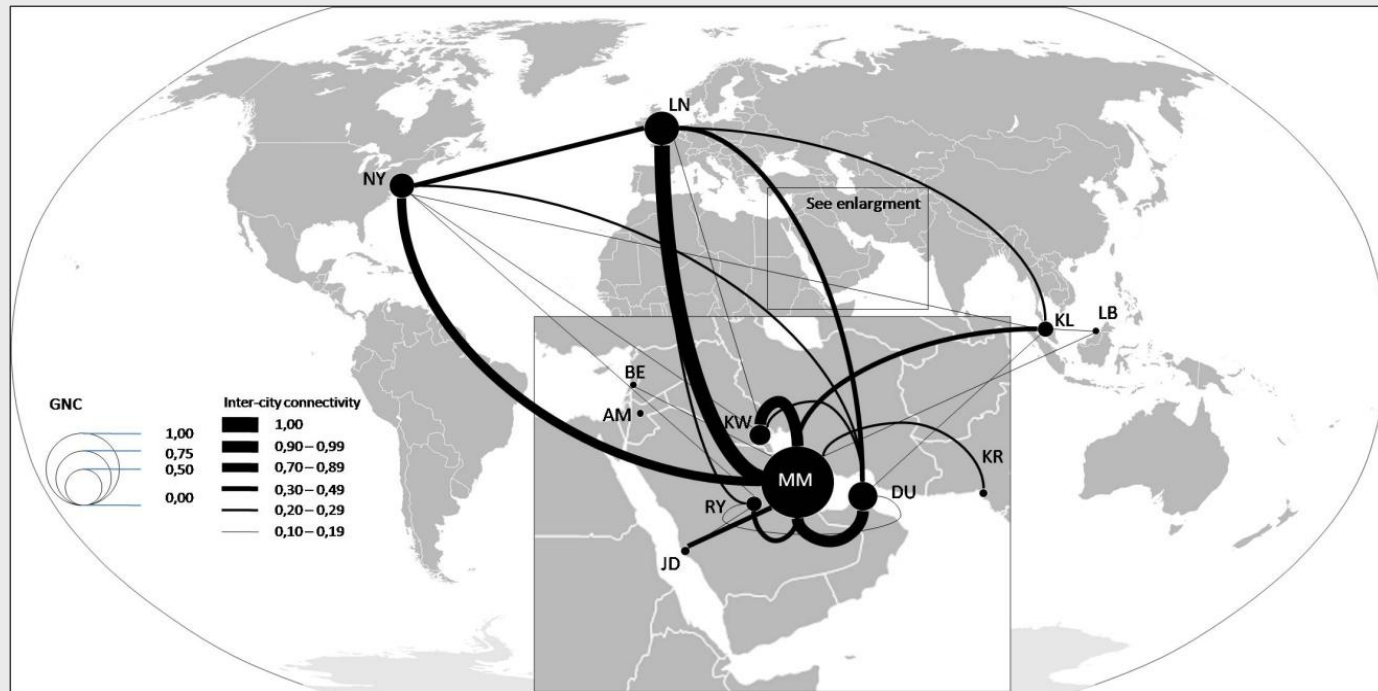
→ Transnational office networks link up IFCs:



Major inter-city relations in the IFS city network (Bassens et al, *Area*, 2010)

3. Globalization of the IFS sector

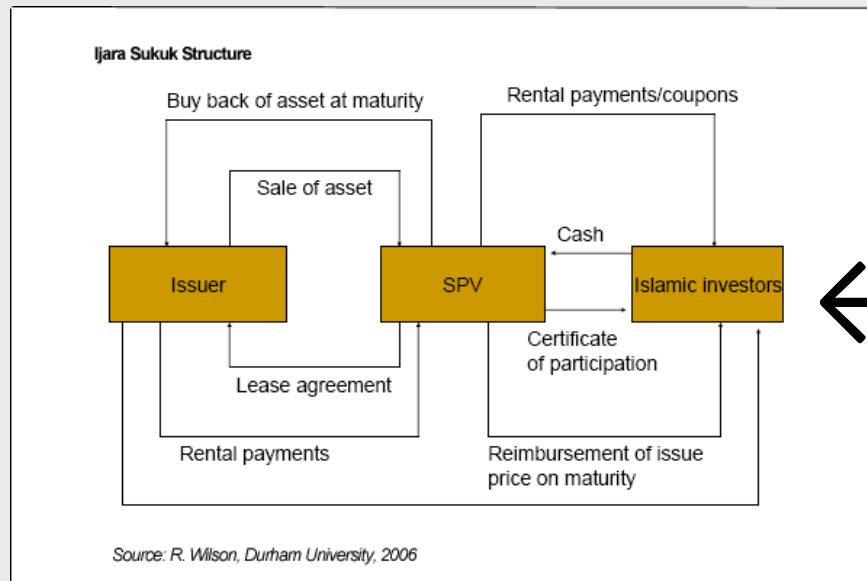
→ Interlocking Shari'a boards:



Major IFS centers in the interlocking Shari'a board network (Bassens et al., 2009)

3. Globalization of the IFS sector

→ **Sukuk issuance:** Shari'a-compliant asset-based/backed notes often linked to **real estate**



Nakheel's Palm Jumeirah (Dubai)

3. Globalization of the IFS sector

→ large conventional banks/IFCs play a crucial role in the Gulf's sukuk issuance process:

- *Sukuk arrangers*: London-based banks with strong links in the Gulf (HSBC, Barclays, Standard Chartered), and others (Deutsche, Citigroup)
 - *Sukuk listings* on 'Western' exchanges (e.g. London Stock Exchange)
 - *Sukuk investors*: arrangers themselves invested heavily in these products
- Growth of the IFS sector is driven by regional and global investments and speculation that the Gulf cities would continue to grow.....

4. Dubai's debt crisis: implications for Islamic finance

26 November 2009: **Nakheel** announces it needs extra time to repay its US\$ 3,5 bn *sukuk*....

How could this happen?

- 'Dubai Inc': government-related enterprises (GREs such as Dubai World and its subsidiaries Nakheel, Emaar, etc.) compete for prestige as they develop real estate/property Dubai
- New property laws: real estate is on the move and subject to speculation since 2002: a bubble in the making
- GREs can easily attract money from regional (high oil rents) and global investors: they become highly leveraged: total debt of Dubai is estimated at US\$ 80bn.

4. Dubai's debt crisis: implications for Islamic finance

BUT 2009: the global financial/economic crisis hits Dubai:

- credit crunch + low oil prices: liquidity becomes scarce
- demand for property crumbles: real estate prices drop (25-50%)
- highly leveraged GREs such as Nakheel announce they cannot repay debts

Dubai loses its credibility:

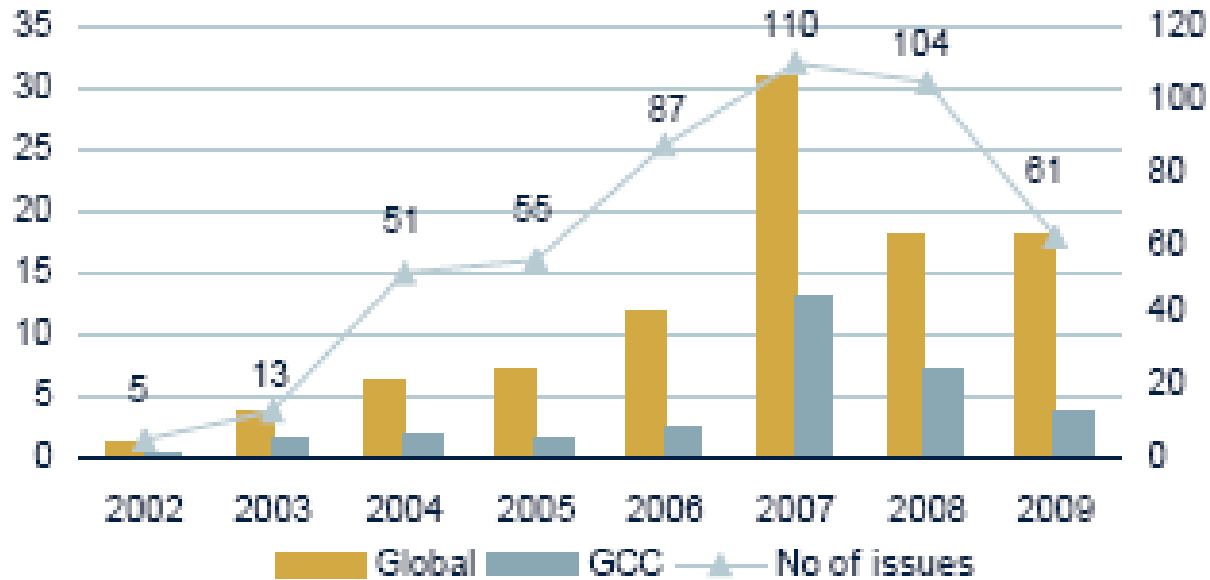
GREs (Dubai World) are downgraded
by rating firms

Credit for Dubai becomes even more
expensive



4. Dubai's debt crisis: implications for Islamic finance

Sukuk issuance volumes since inception



Source Dealogic

4. Dubai's debt crisis: implications for Islamic finance

- **Dubai crisis**, not an Islamic finance crisis?
- **Real economy**: yes, but danger of speculative **bubbles in real estate** market
- Critique concerning **Shari'a-compliance** (guaranteed return makes them like bonds): Taqi Usmani. Form before principle?
- BUT: Need for Islamic securities such as sukuk: **secondary market** for liquidity management
- **Involvement of large interest-based banks** and 'mainstream' IFCs is likely to continue as the sector continues to globalize.



Thank you for your attention!
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