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Implications of Dubai's Debt Troubles

(December 2009)

GRC Reports



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Introduction

The debt standstill request for the government-owned companies Dubai World and Nakheel marks a watershed event in the economic development of Dubai. Before this, markets had assumed an implicit government guarantee for such companies; now that such guarantee has not materialized and Abu Dhabi has so far failed to show up for the rescue in these two cases, refinancing on international markets will be more expensive or impossible. Matching increased costs of capital with growing economic activity will be challenging in the prevailing global environment. Therefore, reliance on Abu Dhabi in the ongoing restructuring process will increase and will come with trade-offs. A possible outcome will be greater centralization of the UAE and a recalibration of Dubai's development strategy. While the real estate sector is still troubled and has failed to deliver on its lofty promises, Dubai has reached critical mass as a regional trading hub and can build on this strength.

Dubai's Debt Structure: How Bad Is It?

Transparency is missing when it comes to Dubai's debt situation. Data

about the consolidated gross debt of the government and the companies it owns is not published. One has to rely on private estimates, which range between \$80 and \$100 billion of debt in the form of bonds and syndicated loans for which information is available in the public domain. In the meantime, Moody's assumes a debt load at the upper end of that range at \$100 billion. There is no public data about bilateral bank loans; if estimates on these are included the number grows further and could be as high as \$120-\$150 billion, as an economist of EFG Hermes has opined. The wide range of estimates reveals considerable uncertainty; given Dubai's GDP of \$82 billion, the debt load represents between 100 and nearly 200 percent of GDP, depending on the estimate, which is in any case substantial. If the lower end of \$80 billion is taken, it represents 9 times the Dubai government's 2008 revenues and has the potential to severely stress fiscal abilities.

The restructuring of Dubai World (DW) will only apply to a fraction of this debt and only to the holding company and two of its subsidiaries. Dubai Ports World (DPW) and Jebel Ali Free Zone (JAFZ) have been exempted from the restructuring which is limited to the real estate subsidiaries Nakheel and Limitless. DPW and JAFZ



have viable business models with ongoing cash flows and have benefited from the recovery in international freight rates since March 2009. They are seen quite favorably by analysts; not everything in Dubai is as apocalyptic as a cursory glance at newspaper headlines sometimes seems to suggest. JAFZ has actually paid a coupon in time only a few days after the standstill request of its parent company. That the DW subsidiaries Istithmar World and Infinity World have been exempted from the restructuring as well have come as a surprise to many as these companies have engaged in leveraged and ill-fated foreign investments that can be hardly regarded as the core business of DW (e.g. MGM Mirage Casino Las Vegas or Barney's New York).

Dubai World's liabilities amount to a widely quoted \$59 billion. However, this figure refers to *liabilities*, not only debt instruments but also unpaid contractor bills or land grants, according to Deutsche Bank. The amount of debt proper has been estimated to be \$22-\$24 billion and on the eve of further announcements Barclay's assumed that \$18 billion of this amount would be part of the restructuring process. After a nerve-racking weekend without detailed information, DW finally specified that a higher amount of \$26 billion of debt will be restructured.

Based on information in the public domain, Barclay's identifies ca. \$16 billion of debt at the three entities that are up for restructuring: \$8.5 billion at Nakheel (including local currency debt), \$5.5 billion at Dubai World holding company and \$1.2 billion at Limitless. This leaves ca. \$10 billion of debt for which no public information exists and which most likely consist of private bilateral loans at Dubai World or Limitless, as Barclay's assumes that Nakheel has not

borrowed much additional funds since its last balance sheet date (December 31, 2008).

With regard to the overall debt load of Dubai, two factors are worrisome: First, the maturity profile of outstanding debts is very short term. Over the next three years, \$50 billion of debts are due, \$12-\$13 billion in 2010 and a staggering \$25 billion in 2011 alone. Dubai will need to refinance this debt at significantly higher costs, as markets have dropped their implicit government assumption. Secondly, there is a substantial amount of bad debt, which is not backed anymore by viable assets or business models. Moody's estimates that this bad debt amounts to \$25 billion. Eventually someone will need to take this loss in a bailout or a restructuring. The bargaining on who that will be has arguably begun with DW's standstill request.

How Refinancing Conditions will Change

Dubai has always been proud to be a state that is run like a corporation. Given the lack of a tax base and the small share (11 percent) of government spending in the overall Dubai GDP, one could in fact argue that the state is its corporations and is as much in trouble as them if they are in dire straits. The market discounted this; with the breakout of the global financial crisis, its assumption of an implicit government guarantee relied increasingly on Abu Dhabi's willingness to help Dubai out if need be. This view seemed to be vindicated by Abu Dhabi's actions. Earlier this year it helped to refinance struggling Borse Dubai and via the Central Bank it provided liquidity support of Dh120bn (\$32bn) to the UAE's banks. Most notably, it purchased a \$10 billion bond issued by Dubai under a \$20 billion bond



program in March 2009. The unsecured five-year bond formally had no strings attached and its very preferential rate of 4 percent would have never been achievable for Dubai on the free market at that time.

Dubai executives encouraged the market's view of an implicit government guarantee by self-confident statements, and the market continued to treat companies owned by the government (e.g. Dubai World) or the ruling family (e.g. Dubai Holding) as "quasi-sovereign" proxies for the credit quality of the Dubai government, which itself has only issued few debts of \$3.7 billion in dollar and local currency and does not have a credit rating.

The first signs of retreat appeared in October, when the Dubai government was able to tap international debt markets for the first time in a year, raising \$2 billion in an Islamic bond issue. In the bond prospectus it distanced itself from its corporations by denying an explicit government guarantee in order to look more attractive for investors in its new bond. This prompted Moody's to downgrade five of the six Dubai government-related companies it is currently rating, even before the recent standstill request.

As the implicit government guarantee has disappeared, markets will need to value Dubai's government-owned companies on a stand-alone basis. However, this is severely compromised, if not impossible, given the lack of transparency and data. Before the standstill request, Moody's gave Dubai companies investment grade rating only because of the implicit government guarantee, which in turn was tied to Abu Dhabi's support waiting in the background. With the exception of DPW, it regarded all of them (DEWA, DIFC Inv., Dubai Holding, JAFZ, Emaar) as speculative grade on a stand-alone basis.

The handling of the standstill request thus far has revealed lack of professionalism and has done little to inspire the confidence of markets. The announcement was scant in detail and was made before major holidays in the Muslim World (Eid) and the US (Thanksgiving). Only two hours before, two government-related Abu Dhabi banks had released \$5 billion for the Dubai Economic Support fund, which had been awaited as part of a second \$10 billion tranche of the bailout program. Investors who banked on this statement and added to their positions in the Nakheel bond were naturally not amused to see more than 30 percent of their investment evaporate only two hours later. The exemption of DPW and JAFZ from the restructuring process was only announced later and, in the meanwhile, investors were left with the rumor mill and statements by non-DW executives who revealed no further details. Instead they preferred to shoot the messenger by blaming the press and analysts. From a city that has aspired to become a regional if not international financial center by aspiring to best practices, markets had expected otherwise.

Effect on Dubai Companies and Their Credit Risk

Apart from the problems at DW, markets wonder whether credit risk may materialize at other Dubai companies. Real estate companies have been at the heart of DW's debt problems and have the most pressing need for restructuring as the planned merger of Emaar with real estate companies of Dubai Holding (Tatweer, Sama, Dubai Properties Group) has shown. A merger of the two real estate financiers Tamweel and Amlak under the umbrella of the Abu Dhabi-based Real Estate Bank and



the Emirates Industrial Bank (EIB) is already pending since late 2008. While DH also has a pronounced exposure to the Dubai real estate market, the maturity profile of its debt spreads out until 2017 and is a less pressing issue compared to the decidedly short term payment schedule of Dubai companies on average. Still, its credit default swaps rose the most (146 percent) of all Dubai entities in the immediate wake of DW's standstill announcement and it must be regarded as the most vulnerable, also because of leveraged foreign investments by its subsidiary Dubai International Capital.

Pressure on the Dubai real estate market will continue, especially in less attractive areas. Price recoveries in the third quarter were not fundamentally underpinned but rather a technical reaction to massive losses of about 50 percent since the price peak in summer 2008. Especially in commercial real estate, a high level of inventories weighs on the market, while a simple counting of lights in apartment buildings at night reveals low occupancy rates. Foreign investment demand was crucial for the erstwhile real estate boom, but it has already faded away because of the global financial crisis and with the lost trust in the wake of the DW debt affair, it will be even more difficult to attract. UBS estimates that it will be difficult to raise the additional finance of \$11 billion for an estimated 40,000 unfinished flats as half of the investors will likely default by the end of 2010. As trust in developers has fallen and prices in the secondary market are below initial purchasing prices, there is an incentive for investors to walk away from ongoing projects, even if this means forfeiting earlier down payments. Overall, UBS expects real estate prices to decline a further 30 percent in 2010.

At the beginning of the year, research by investment banks estimated that there would be a significant population decline of 8 percent (UBS) to 17 percent (EFG Hermes) in 2009. However, official figures by the federal Ministry of Economy have maintained a population *increase* in 2009 of 6.3 percent on the UAE level and of even 7.8 percent in Dubai, mainly due to migration. Dubai is certainly not a ghost town as some media reports seem to want us to believe and the mass exodus of expatriates that some have expected did not materialize, although traffic congestion has eased visibly. Still, it is difficult to see where the alleged newcomers have supposedly found work, given the obvious decrease in construction activity and the layoffs of white collar expatriates in the real estate, finance and media industries. Given the varying estimates and figures, suffice to say that population figures can be politically sensitive and that the officially alleged increase in Dubai's population in 2009 was not enough to ward off a significant deterioration of its real estate market.

Compared to the ailing real estate sector, companies with ongoing cash flows and established business models are more resilient. In international comparison, DPW, the world's fourth largest port operator, has fared sufficiently well. It may only face a slightly negative revenue growth and its maturity profile stretches out as far as 2037. The preliminary economic recovery since March 2009 has helped a lot of Dubai companies with an internationally diversified risk exposure: JAFZ, DPW and Emirates Airline benefitted from recovering trade and freight rates, while Dubai Aluminum (DUBAL), which contributes around 7 percent to Dubai GDP was helped by improving aluminum prices after the steep correction in commodity



prices in the second half of 2008. Many of the more viable companies are organized under the umbrella of the Investment Corporation of Dubai (ICD), which is increasingly emerging as Dubai's "good bank" of assets according to the Financial Times.

Established free zones such as Media City and Internet City, which are run by DH-owned Tecom, have a relatively stable base of long term tenants. In comparison, newer economic cities such as Silicon Oasis or DuBiotech, the Dubai Biotechnology and Research Park, will be less resilient as they are in an earlier stage of development and have less obvious competitive advantages, particularly with regard to available qualified human resources.

DIFC might also be in a less advantaged position. The financial sector has been particularly hit by the global crisis, and Dubai's image as a financial hub has been severely tarnished by the DW debt saga. Regional competitors like Bahrain and Qatar may be able to use this to their advantage. Abu Dhabi has financial ambitions of its own with a planned financial city on Sowwah island, and it aspired to host the Central Bank of the planned GCC currency union before withdrawing from the project when the seat went to Riyadh. With Saudi Arabia's accession to the WTO, the GCC's largest economy is also in a better position to realize ambitions in the financial field, which it has formulated with the project of the King Abdullah Financial District in Riyadh.

The Dubai Electricity and Water Authority (DEWA) is the only government-owned company whose debt has an *explicit* government guarantee. As a utility provider, it has a more stable business model by nature and might actually profit from the economic downturn. It has been under immense pressure to increase power generation and

water desalination capacity in order to keep pace with the city's rapid growth, and such capacity expansion is now cheaper to buy. DEWA was even able to refinance \$2.2 billion at the height of the global financial crisis in April 2009. Only days after the standstill request last week, DEWA appointed Citigroup and Standard Chartered Bank on November 30 to arrange a bond issue of up to \$2 billion in the first quarter of 2010. DEWA did not disclose for what it would need the bond, but its offering will be an interesting litmus test of how the market views an explicit Dubai government guarantee, now that the implicit guarantee is gone.

The effect on banks in the UAE is difficult to gauge, as most of their exposure is likely to be in bilateral loans that are not in the public domain. National Bank of Abu Dhabi (NBAD) is the only UAE bank that has made an official announcement about its aggregate exposure to Dubai World. It has put it at \$345 million, which would be rather modest and double its non-performing loan ratio to only 2 percent in case of default. Standard Chartered points out that "in the absence of detailed disclosure from the banks, the large exposure limit set by the Central Bank of the UAE (25% of the bank's capital to commercial public sector entities)" can be taken as "a better indication of what the 'worst case' maximum exposure to Dubai World and Nakheel could be for each bank." As there is no aggregation of exposure to different legal entities, banks could treat DW and Nakheel as two different entities, which could theoretically increase aggregate exposure to 50 percent in the worst case scenario. Based on this methodology, and by comparing the capital of UAE banks with their total outstanding loan volume, Standard Chartered arrives at a maximum exposure of \$13.4 billion of UAE banks in a worst case



scenario, which would increase their NPL ratio to 10-16 percent (with the exception of NBAD which has declared its exposure and in its case this ratio would be 2 percent).

Standard Chartered's Worst Case Scenario

	Estimated worst case exposure (\$ bn)	Worst Case NPL ratio in %	NPL ratio June 09 in %
Emirates NBD	4.4	9.7	1.5
NBAD	0.3*	2.0	1.1
ADCB	2.7	12.8	4.2
First Gulf Bank	3.0	13.4	1.1
UNB	1.4	11.6	1.3
Mashreqbank	1.6	15.7	2.2

Source: Standard Chartered, "Dubai World – Impact on the UAE Banks," *Credit Research*, December 1, 2009. NPL= Non Performing Loan

*has been officially declared

Citing unnamed banking sources, an AFP story on November 29 put exposure of Abu Dhabi and Dubai banks to DW between 30 and 40 percent of banks' capital, with Abu Dhabi Commercial Bank (ADCB) having exposure between \$2.18 and \$2.45 billion and First Gulf Bank of \$1.36 billion. In the case of ADCB, this would be pretty close to Standard Chartered's worst case scenario in the table above.

While this certainly would affect the profit quality at banks and might even make their bondholders nervous, it has to be stressed that there is a three year guarantee by the UAE government on bank deposits since October 2008. The guarantee was implemented in the wake of the global financial crisis and extends to all national and international banks with "significant operations," excluding regional and Iranian banks. The UAE Central Bank has also made additional liquidity facilities available to UAE banks to underscore this guarantee and quell

any speculation about possible bank runs.

Risk of Regional and International Contagion?

Markets initially feared substantial risk of contagion on a regional and even international level. Credit default swaps of other GCC countries rose as well, albeit they were less pronounced than the ones of Dubai, and international equity markets tumbled as they feared that Dubai could spark a crisis of emerging market debt in general.

Market Reaction to DW Standstill Request: Spreads of Credit Default Swaps (CDS)

	5y CDS Nov. 23	5y CDS Nov. 27	Relative change in %
Dubai Holding	670	1650	146%
Emirates Bank	345	800	132%
Dubai	317	630	99%
DP World	355	700	97%
NBAD	135	250	85%
Abu Dhabi	100	175	75%
Mubadala	133	225	69%
ADCB	210	305	45%
Bahrain	175	225	29%
Qatar	94	120	28%
Russia	191	215	13%
Hungary	217	242	12%
BarCap USD GCC bonds index	237	302	27%
BarCap USD EM Sovereign Index	315	323	3%

Source: Barclay's Capital, "Dubai's Debt – Whose Problem is It?" *Emerging Market Research*, November 30, 2009.

Such fears say more about the still fragile nature of global financial markets than about the contagion potential of Dubai, which is limited. Neighboring countries with significant oil revenues and foreign reserves have a very different economic structure from Dubai.



Saudi Arabia actually has one of the lowest levels of government debt in the world with a share of only 13.4 percent of GDP, as Bank Saudi Fransi points out. This is a number other countries can only dream of; the US is at 50 percent and rising and India is at 81 percent, not to mention countries like Italy or Japan. The real estate bubble of Dubai has also been unique in the region – many neighbors started to copy it, but in hindsight they were lucky to be late. There is certainly exposure by GCC investors to Dubai investments, but a full fledged contagion of the Dubai debt crisis is unlikely, also because oil prices have held out pretty well around \$75 per barrel.

The lack of potential contagion applies all the more to international markets. Dubai is not comparable to China, Brazil or the US real estate market. It has also not functioned as counterparty for deals in trillions of dollars of OTC derivatives like Lehman Brothers or AIG. To put it into perspective, one can take a look at the magnitude of GDP figures: world GDP is at \$61 trillion, while the GCC GDP is only \$1.1 trillion, and that of the UAE is \$228 billion of which \$82 billion accrues to Dubai. International banks have lent substantial sums in the UAE, but compared to their overall loan volume the exposure should be manageable, as JP Morgan points out. The largest exposure is with HSBC, Standard Chartered, Barclay's, and RBS/ABN Amro.

Foreign Banks: Exposure to UAE in 2008

	Outstanding Loans in \$ bn	Loans to UAE as % of Total Group Loans
HSBC	17.03	1.8%
Standard Chartered	7.77	4.4%
Barclays Bank	3.58	0.4%
RBS/ ABN Amro	2.24	0.4%
BNP Paribas	1.69	0.2%

Source: JP Morgan, "UAE-Exposure at Risk Analysis," *Europe Equity Research*, November 27, 2009

Abu Dhabi's Role and the Growing Centralization of the UAE

As Dubai's access to international capital markets has diminished, it will need to rely increasingly on Abu Dhabi besides making necessary restructuring moves. Despite its support on numerous occasions earlier this year, Abu Dhabi has not been ready to lend its helping hand to DW and Nakheel for the time being. An unnamed senior Abu Dhabi official told Reuters that Abu Dhabi will support Dubai on "a case by case basis" and that it will "pick and choose" which companies it will support.

On November 25, Dubai did not receive the full second \$10 billion tranche of a \$20 billion bond program as originally expected but only \$5 billion and the proceeds of the bond were not supposed to be used for the bailout of Dubai World and Nakheel, but for other liquidity needs of the emirate that are administered by the Dubai Financial Support Fund (DFSF). The DFSF was founded in July in order to assist Government-Related Entities (GREs) that are undertaking projects of strategic importance within Dubai. It reports to Dubai's Supreme Fiscal Committee (SFC), but nothing is known about its allocation strategy and priorities so far.

Abu Dhabi's support for Dubai in the current financial crisis is selective and not unconditional. Abu Dhabi shows that it is ready to practice tough love and force a restructuring of Dubai business entities that are currently not viable or might not fit into its own and the UAE's overall development plans. While it remains committed to a selective bailout, it seems unwilling to foot the bill all by itself. It is ready to accept a considerable reputation risk for Dubai and



the UAE as a whole by letting Dubai walk the thin line of debt restructuring and default and making international investors bear part of the burden. Speculation about trade-offs is increasingly shifting from rumored secret buyout arrangements that are impossible to verify to a power shift to Abu Dhabi within the federal structure of the UAE.

Payoffs for Abu Dhabi's bailout might rather be on a political level. Abu Dhabi could demand a strengthening of federal authority, while Dubai would need to relinquish certain sovereign rights, such as control of customs, which so far remains on the level of individual emirates. Hints at increased centralization are already discernible, with Abu Dhabi and federal institutions playing a more visible role in national development policy and Shaikh Mohammed of Dubai increasingly appearing in his role as Prime Minister of the UAE rather than as Ruler of Dubai. He launched a dedicated website at the beginning of the year that highlights his prominent role in federal politics.

It is important to keep in mind that the various emirates of the UAE had shown a strong sense of independence during the genesis of the federation, especially Dubai and Ras Al Khaimah. In the 1970s, the UAE still resembled a confederation than a federation in many ways and consensus about further unification steps had to be delicately balanced. Individual emirates were reluctant to cede authority and revenues to a central government that still had to assert itself amidst tribal allegiances and unresolved border issues.

In 1979, a proposal by Abu Dhabi to strengthen federal ministries and reduce the autonomy of individual emirates faced stiff resistance from Dubai and Ras Al Khaimah, which preferred the rather loose confederation that had prevailed until

then. The compromise that ensued led to a greater integration of Dubai into federal politics. Besides being Vice President of the UAE, the ruler of Dubai would henceforth also be its Prime Minister presiding over the Council of Ministers – a compromise that has proven to be successful and has lasted to this day. Still, Dubai continued to maintain a local military force that was only integrated into the federal Union Defense Force (UDF) in 1996.

While the UAE has shown a tendency towards more unity, lack of centralization has remained an issue even in foreign affairs. During the Iran-Iraq war of the 1980s, Abu Dhabi, Ras Al Khaimah, Ajman and Fujairah supported Iraq, while Dubai, Sharjah and Umm Al Quwain leaned more towards Iran, their most important trading partner and home country of a large merchant expatriate community in these emirates. Operation Desert Storm for the liberation of Kuwait and the US invasion of Afghanistan equally led to considerable disagreement between different emirates. Until 9/11, the UAE was one of the three states recognizing the Taliban regime besides Pakistan and Saudi Arabia. The Abu Dhabi-led anti-Iranian group amongst the emirates had favored a "Sunni axis" that also included Taliban-led Afghanistan in order to counter perceived "Shi'a expansionism."

Centralized control of customs authority in exchange for financial help would give Abu Dhabi a firmer grip on implementation of sanctions policies against Iran, which has been repeatedly demanded by the US in the past. Such a move would also be in line with its own tough stance with regard to the regional ambitions of Iran. The UAE has been firm in its opposition of the Iranian occupation of three UAE islands in the Gulf and has put it repeatedly on the agenda of the Arab League and other international organizations.



Control by the individual emirates is also evident in other areas such as the police force, parts of the judiciary, education, transport, utility companies, compilation of statistics and stock markets. The country's Central Bank was only founded in 1980 and its role in the overall banking framework is relatively underdeveloped if compared to other countries in the region.

The UAE needs increasing unification of policies and standards for its ambitious development drive. It also needs substantially improved statistics which so far are often not available in a timely, complete and consistent fashion. Like elsewhere, there will need to be more regulation of capital markets, while a unification of the stock markets in Dubai and Abu Dhabi could strengthen the position of the UAE as a niche player in international capital markets. In this context, it needs to be remembered that Abu Dhabi played a major role in the refinancing of Borse Dubai in February 2009. A looming electricity shortage will require the development of Abu Dhabi's sour gas reserves and new power generation capacities, possibly fueled by nuclear and renewable energy. Urban development is increasingly intertwined with people living in one emirate and working in the other and coordinated planning will be required especially in the field of transport networks and railroads. More unification and centralized control of the judiciary could contribute to furthering the rule of law and improve the international image of the UAE as an investment destination, which has been bruised recently by lack of corporate governance and investor protection. Finally, education plays a pivotal role in emiratization efforts which aim at increased integration of young nationals in the workforce.

The Nakheel Sukuk and Immediate Developments Ahead

On December 14, the \$3.5 billion sukuk of Nakheel will be due for payment. While postponement of bilateral loans behind the scenes has been somehow expected, the rating agencies have made it repeatedly clear that repayment of publicly traded debt instruments would be regarded as a litmus test and involuntary rescheduling as a default, which would seriously harm credit sentiment for Dubai. For a voluntary restructuring, 75 percent of the bondholders would need to approve changes to the terms of the sukuk at an extraordinary general meeting which would require a 21-day notice period. As there is a two-week grace period after December 14, such a meeting would need to be held no later than December 28 and would need to be announced no later than December 7. Otherwise, chances for a voluntary restructuring look slim and a default becomes more likely.

A group of international investors led by the US hedge fund QVT Financial LP has hired Ashurst, a London law firm, to advise them on their options, according to a report by the London-based Times. The group accounts for more than 25 percent of Nakheel's bonds by value and would thus have a veto power at a possible general meeting of bondholders. According to the Times, the group examined two possible approaches in case of a default. One would seek to seize Nakheel's real-estate assets in Dubai, the other would focus on Dubai World's parent-company guarantee on the debt, which could open the way for a claim against more valuable assets abroad, such as P&O Ferries Ltd. or the Queen Elizabeth 2 cruise liner. As the underlying assets of



the Nakheel sukuk are undeveloped plots of the Dubai Waterfront project, which is currently on hold, their current market value is likely to be low.

There is no legal precedent for recourse to assets in case of a sukuk default thus far. In many cases, sukuk are "asset based" rather than "asset backed." They were designed to satisfy legalistic requirements of Shari'a law in order to circumvent the ban on interest, not to establish a waterproofed recourse to underlying assets. The Declaration of Trust in the Nakheel sukuk contract is governed by English law, and considerable ambiguity exists whether all its stipulations would be applicable under UAE law or whether assets of government-related entities can be seized under UAE law at all. As Dubai, Bahrain and other Gulf countries aspire to play a leading role in the growing global market of Islamic Banking, it will be important to convincingly clarify such legal ambiguities and improve regulation. Doubts about the viability of sukuk contracts have already been raised by a verdict of the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in 2008 when it declared a majority of them as non-Sharia compliant for lack of real risk sharing on the part of the investor. The Nakheel sukuk would be the third one to default after Kuwait Investment Dar's \$100 million sukuk in May and the one of a Saad Group subsidiary over \$650 million in June, which is registered in Bahrain. While a bond default can happen, it would be important to establish convincing legal clarity of sukuk structures in such a situation, otherwise their future issuance and tradability might be seriously affected.

According to the Abu Dhabi-based newspaper *The National*, Dubai advisers

have been discussing four possible options with regards to the Nakheel bond: a) a full repayment of the bond, b) offering bondholders 80 percent of the redemption value in a voluntary restructuring, c) a debt holiday followed by a rescheduling of debt and d) liquidation of Dubai World assets in response to legal action by bondholders. Whatever scenario unfolds, it will have wide ranging implications for Dubai's future creditworthiness and access to international capital markets.

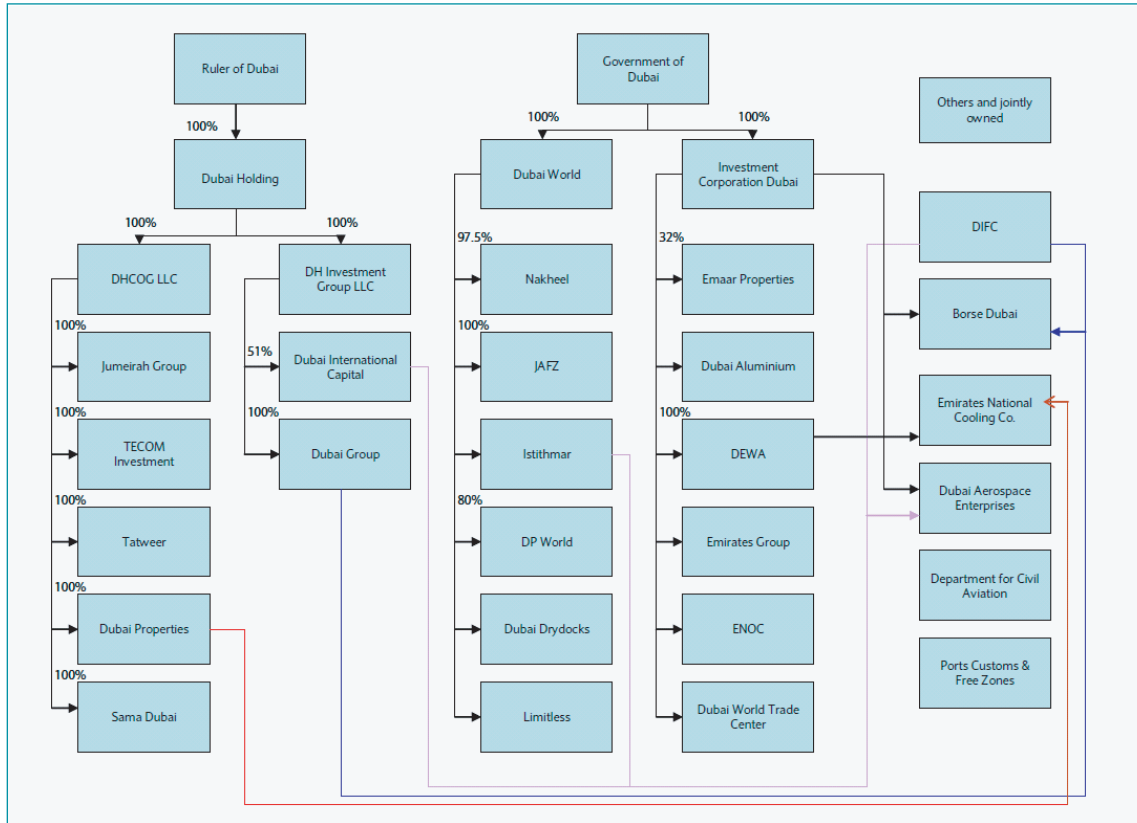
Conclusion

Dubai's debt predicament requires decisive restructuring, especially in the ailing real estate sector. Compared to other countries in the Middle East, Dubai has a competitive advantage in terms of infrastructure, lifestyle and business facilitation. It also has a successful role to play as a regional trading hub, provided it can rid itself of past exuberance. Markets can stomach frankness if it is administered with a clear strategic vision and decisive action, but they are very sensitive to prolonged periods of uncertainty. With declining oil revenues in Dubai and the impact of the financial crisis, funding of UAE development efforts relies more on Abu Dhabi than in the past. The ambitious development goals of the UAE and its wish to play a more visible role in international affairs will also require a more centralized approach to planning and institution building. Rather than aiming at rumored equity buy-outs, Abu Dhabi will possibly try to forge a consensus for more concentration of responsibilities on the federal level in exchange for its ongoing financial help for Dubai and other emirates.



Appendix

Structure of Dubai Inc.



Source: Barclay's Capital



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