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Distressed Debt Opportunities in the COVID-19 Environment – the UAE and Saudi Arabia

Following the immediate aftermath of the COVID-19 crisis, the banks at large showed a great degree of flexibility and primarily focused on stabilising defaulting loans. However this is likely to change as the crisis continues to unfold, with falling valuations and more strain on the lenders' internal resources. This change will inevitably present highly attractive opportunities for distressed debt buyers. Undoubtedly success will be achieved with those with capital to deploy and the ability to make decisions and act quickly!

Setting aside any potential practical difficulties arising from loan valuations, the trading of loans also raises complex legal issues which should be considered carefully by all secondary loan market participants. Such issues include those relating to regulation, guarantees, security, tax and sanctions. This article focuses on the regulatory aspect of secondary debt trading in the UAE and Saudi Arabia.

Generally speaking, lending is a regulated activity in the United Arab Emirates (the **UAE**) and the Kingdom of Saudi Arabia (**Saudi Arabia**) requiring companies offering debt (whether banks or non-banks) to obtain a license from the relevant regulatory bodies.

Given the licensing requirements, the majority of the loans advanced to borrowers in the UAE and Saudi Arabia are advanced by banks and/or finance companies which hold a lending licence.

Once a loan has been advanced, a lender can either hold that loan to maturity or it can sell it to a third party in the secondary debt market. A third party purchasing a loan becomes the lender of record and as a lender of record it will be affected by all the issues that flow from the advancing of loans to borrowers in the UAE and Saudi Arabia. Accordingly, a third party wishing to purchase a loan from the original lender of that loan must first and foremost determine whether it also requires a lending licence.

LOAN ORIGINATION

A number of practices have evolved with respect to the making of loans to borrowers in the UAE and Saudi Arabia by entities which do not have a lending licence. Examples include the provision of financings by international banks for large infrastructure projects, receivables and mezzanine financing provided by entities established outside the UAE and Saudi Arabia and sale and lease back transactions structured as financing arrangements (i.e. the owner of an asset sells such asset to a fund, that fund in turn leases such asset back to owner with the owner having the obligation to pay rent and repurchase such asset at a set price after a set period of time).

The providers of such “alternative finance arrangement” take a view that a lending licence in the UAE or Saudi Arabia is not required as they (a) are not conducting a business activity in the UAE/Saudi Arabia, (b) are not actively marketing their services in the UAE/Saudi Arabia, (c) are involved in one off financing transactions and/or (d) have an entity with the requisite arranging license in the DIFC / ADGM. Such a view is not without risk, specifically enforcement risk. If a borrower defaults, the lender will typically have to take proceedings to recover the money advanced to that borrower. As part of those enforcement proceedings there may be a requirement to show the court that the maker of the loan has the requisite licence to lend, without a licence, recovery through the local courts may become problematic (or at least this is an argument that a borrower may raise in any such proceedings).

SECONDARY DEBT TRADING OF DISTRESSED LOANS

Any person acquiring a loan in the secondary debt market faces the same regulatory issues as those faced by the person who originally advanced that loan, namely it will need to be a licenced lender. Therefore, when purchasing such loans, market participants without a lending license typically purchase such loans by way of a participation.

In a funded-participation, the grantor (being the principal lender under the loan agreement e.g. a bank with lending licence) remains the lender of record and enters into a “back to back” arrangement with the participant (being the purchaser of the loan). The participant pays an amount to the grantor to acquire the rights to the loan (when the loan is non-performing the purchase price will typically be at a discount to the face value of the loan) and the grantor continues to front the relationship with the borrower. In fact, subject to the terms of the loan agreement, the borrower does not need to be made aware of such participation arrangement. Any amounts paid by the borrower to the grantor (including any enforcement proceeds) are then passed on by the grantor to the participant. The participant becomes a creditor of the grantor, and does not have a direct relationship with the borrower or any rights under the loan agreement vis-à-vis the borrower. In such circumstances, the participant is taking a double credit risk, against both the borrower and the grantor. Under a funded-participation the grantor typically takes instructions from the participant in relation to the management of the loan, including any enforcement action against the borrower.

One of the key practical issues which arises under a participation arrangement is that grantor (which continues to have the relationship with the borrower) may not be prepared to take an aggressive approach against the borrower (such as enforcing its security) because of potential reputational and/or relationship issues involved. Ideally, the participant wants to replace the grantor with someone who is independent of the borrower and is therefore prepared to act on the instructions of the participant.

As an alternative to a participation arrangement, we have worked with a number of clients to identify entities in the UAE and Saudi Arabia which hold a lending licence and are agreeable to becoming the lender of record. The loan (and any related security package) is therefore transferred to the new lender of record identified by the purchaser. To provide our clients with the added comfort that the suggested arrangements do not fall foul of the UAE or (as applicable) Saudi Arabian lending rules, we have recommended that their economic interest in the loan is structured as a sukuk offering which is approved by the necessary regulatory authority (e.g. CMA in Saudi Arabia and ADGM/DIFC and/or ESCA in the UAE). Under such structures, the purchaser of the loan extracts its return through the sukuk and is able to control the lender of record through the sukuk transaction documents.

Purchasing non-performing loans in the UAE and Saudi Arabia presents certain commercial, practical and legal issues (which include the regulatory issues discussed in this article and issues with respect to legacy liabilities when acquiring loans secured against real estate developments, i.e. a purchaser of a real estate development in Dubai will typically be required to honour all legacy contracts, such as off plan sale contracts). However, the market for non-performing loans is growing in the Middle East and we have seen an increase in the number of UAE and Saudi Arabian lenders discreetly looking to off load such loans. The legal framework in the UAE and Saudi Arabia for enforcing rights is continuously improving which in turn provides the purchasers of non-performing loans greater certainty on recovery rates, e.g. the process for enforcing a UAE judgement in India has been streamlined making it easier to enforce against defaulting borrowers who leave the country to avoid the consequences of defaulting on a loan. Central banks in the region are also working with interested parties to development a regulatory landscape which will make it easier for non-licenced entities to purchase and work out non-performing loans.

Please do not hesitate to contact any of us listed on this article should you wish to discuss any of the issues highlighted under this article or with respect to secondary debt trading in the UAE and Saudi Arabia.