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**RECOVERY, RESOLUTION AND
INSOLVENCY ISSUES FOR
INSTITUTIONS OFFERING ISLAMIC
FINANCIAL SERVICES**

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Note: This Working Paper should not be reported as representing the views of the Islamic Financial Services Board (IFSB). The views expressed are those of the authors and do not necessarily reflect those of the IFSB.

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ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
ADIB	Abu Dhabi Islamic Bank
AI	Ailing institution
AT1	Additional Tier 1
BCBS	Basel Committee on Banking Supervision
BoE	Bank of England
BRRD	Bank Recovery and Resolution Directive
BRSA	Banking Regulation and Supervision Agency
CA	Competent authority
CAR	Capital adequacy ratio
CET1	Common Equity Tier 1
CNAV	Constant net asset value
CoCo	Contingent convertible
DIS	Deposit insurance scheme
D-SIB	Domestic systemically important bank
EBA	European Banking Authority
ECB	European Central Bank
EU	European Union
FDIC	Federal Deposit Insurance Corporation
FSB	Financial Stability Board
FSOC	Financial Stability Oversight Council
GDP	gross domestic product
GFC	Global Financial Crisis
G-SIB	Global systemically important bank
G-SIFI	Global systemically important financial institution
IAH	Investment account holders
IAIG	Internationally Active Insurance Group
IAIS	International Association of Insurance Supervisors
IDB	Islamic Development Bank
IFH	Ihlas Finans House
IFSI	Islamic financial services industry
IIFS	Institutions offering Islamic financial services
IMF	International Monetary Fund
IRR	Investment risk reserve
IRTI	Islamic Research and Training Institute
ISRA	International Sharī'ah Research Academy for Islamic Finance
KA	Key Attributes
LCs	Letters of credit
LOLR	Lender-of-last-resort facility
MENA	Middle East and North Africa
OFR	Office of Financial Research
OIC	Organisation of Islamic Cooperation
OLA	Orderly Liquidation Authority
PER	Profit equalisation reserve
PRF	Participants' risk fund
PSIA	Profit-sharing investment account
PSIFIs	Prudential and Structural Islamic Financial Indicators
QFC	Qualified financial contracts
QIIB	Qatar International Islamic Bank

RA	Resolution authority
RPSIA	Restricted profit-sharing investment account
RRP	Recovery and resolution plan
RSA	Regulatory and supervisory authority
RWAs	Risk-weighted assets
SCDIS	Sharī'ah-compliant deposit insurance scheme
SDIF	Savings Deposit Insurance Fund
SIB	Systemically important bank
SIFI	Systemically important financial institution
SLOLR	Sharī'ah-compliant lender-of-last-resort facility
SME	Small and medium enterprise
SPV	Special purpose vehicle
T2	Tier 2
TLAC	Total loss-absorbing capacity
TO	<i>Takāful</i> operator
UK	United Kingdom
UPSIA	Unrestricted profit-sharing investment account
US	United States

GLOSSARY

Bail-in	A bail-in takes place before a bankruptcy. Under Basel III, regulators have the power to impose losses on bondholders/ <i>ṣukūk</i> holders while leaving untouched other creditors of similar stature.
Bankruptcy	A legal declaration of one's inability to pay debts owed.
Critical economic functions	Activities, services or operations carried out by a financial institution, the discontinuance of which is likely to disrupt financial stability in the jurisdiction or services that are essential to the real economy. This may be due to the size, market share, external and internal interconnectedness, complexity or cross-border nature of the activity, service or operation.
D-SIFIs	A financial institution that, because of its size and/or interconnectedness, could pose a material risk to financial stability and the real economy on a domestic scale if it were to fail.
G-SIFIs	A financial institution that, because of its size and/or interconnectedness, could pose a material risk to financial stability and the real economy on a global scale if it were to fail.
<i>Iflās</i>	An Arabic term for "bankruptcy". It refers to the scenario where a person's debt exceeds his or her assets, as well as to the inability to meet liabilities as they fall due.
<i>Ijārah</i>	An agreement made by an institution offering Islamic financial services to lease to a customer an asset specified by the customer for an agreed period against specified rental. An <i>ijārah</i> contract commences with a promise to lease, and is immediately binding on the part of the potential lessee.
Insolvency	A debtor's inability to pay his or her creditors. The term also refers to an excess of liabilities over assets.
Investment risk reserve (IRR)	The amount appropriated by the institution offering Islamic financial services out of the income of investment account holders (IAH), after deducting the <i>muḍārib</i> 's share, in order to cushion against future investment losses by the IAH.
<i>Maqāṣid al-Sharī'ah</i>	The fundamental objective of Sharī'ah, which is to promote and protect the interests of all human beings and avert any harm that may affect their wellbeing.
<i>Muḍārabah</i>	A partnership contract between the capital provider (<i>rabb al-māl</i>) and an entrepreneur (<i>muḍārib</i>) whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur. Profits generated by that enterprise or activity are shared in accordance with the percentage specified in the contract, while losses are to be borne solely by the capital provider unless the losses are due to misconduct, negligence or breach of contracted terms.

<i>Mushārah</i>	A contract between the institution offering Islamic financial services and a customer whereby both would contribute capital to an enterprise, whether existing or new, or to ownership of real estate or a movable asset, on either a temporary or a permanent basis. Profits generated by that enterprise or real estate/asset are shared in accordance with the terms of the <i>mushārah</i> agreement, while losses are shared in proportion to each partner's share of capital.
Profit equalisation reserve (PER)	The amount appropriated by the institution offering Islamic financial services out of the <i>muḍārah</i> income, before deducting the <i>mudārib</i> 's share, in order to maintain a certain level of return on investment for investment account holders and to increase owners' equity.
<i>Qarḍ</i>	A loan intended to allow the borrower to use the funds for a period with the understanding that this would be repaid at the end of the period, where it is not permissible for any increase in cash or benefit.
Recovery plan	A plan containing a series of clear and predefined options that will be executed by a financial institution in the face of financial stress. The plan should be integrated into the financial institution's existing governance framework and processes. It should include regular monitoring of early warning signs and predefined triggers to identify the necessary actions, and regular reviews and updates.
Resolution pack	An information dump maintained and updated by a regulatory and supervisory agency (RSA)/responsible resolution authority. It summarises a financial institution's profile, size, liquidity and capital profile, and lists the RSA's own opinion on how best to effect resolution of the firm if needed. The pack also contains a list of key economic functions carried out by the firm (if any), and the key people to contact in the event of resolution being needed.
<i>Ṣukūk</i>	Certificates that represent a proportional undivided ownership right in tangible assets, or a pool of tangible assets and other types of assets that are Sharī'ah compliant.
<i>Takāful</i>	The term is derived from an Arabic word meaning "solidarity", whereby a group of participants agree among themselves to support one another jointly against a defined loss. In a <i>takāful</i> arrangement, the participants contribute a sum of money as wholly or partially <i>Tabarru'</i> (donation) into a common fund, which will be used for mutual assistance for the members against a defined loss or damage, according to the terms and conditions of the <i>takāful</i> .
<i>Wakālah</i>	An agency contract where the customer (principal) appoints the institution offering Islamic financial services as agent (<i>wakīl</i>) to carry out the business on their behalf and where a fee (or no fee) is charged to the principal based on the contract agreement.

ABSTRACT

This working paper¹ examines what an effective recovery and resolution framework looks like for institutions offering Islamic financial services (IIFS). The overarching issue for the Islamic financial services industry (IFSI), from a structural, procedural and juridical perspective, is the requirements of Sharī'ah. The recovery of capital and liquidity positions, the resolution framework and tools that a recovery and resolution authority should consider with respect to IIFS, and other complexities of an IIFS operating in an interest-based secular system while taking cognisance of Sharī'ah considerations, are not fully considered by currently available standards on this subject at the international level. The main objectives of the paper are to: (a) review the requirements of a robust recovery and resolution framework for IIFS through literature review and jurisdictional analysis; (b) consider and analyse key recovery, resolution and bankruptcy principles in the context of Islamic finance industry practices and Sharī'ah requirements; and (c) indicate specific issues that require further consideration by regulatory authorities/policymakers and IIFS regarding recovery, resolution and bankruptcy.

The scope of the paper is cross-sectoral and considers Islamic banking, capital markets and *takāful*. The key issue being addressed by this paper is the need to harmonise the Sharī'ah principles of a recovery and resolution plan (RRP) with the bankruptcy and insolvency frameworks that are currently embodied in secular legal systems. This paper examines the possibility of adopting self-insured structures and mechanisms to help safeguard the IFSI. It discusses bail-in features of shareholder equity (Common Equity Tier 1, or CET1) and *mushārah* AT1 *shukūk* from regulatory and Sharī'ah perspectives. The paper also attempts to investigate whether the bail-in concept of a mandatory debt write-down by a resolution authority is compatible with Sharī'ah. It focuses on the treatment of investment account holders (IAH) in an insolvency and the treatment of the profit equalisation reserve (PER) and investment risk reserve (IRR) funds in an insolvency scenario. Ultimately, the paper sheds light on a number of legal, structural and operational issues in the context of recovery, resolution and insolvency for IIFS, with the aim of making policymakers aware of these challenges.

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EXECUTIVE SUMMARY

Since the banking collapses witnessed during the Global Financial Crisis (2007–8), and the detrimental repercussions they have had on the “real economy”, recovery, resolution and insolvency have been at the very forefront of the global regulatory agenda. The Islamic finance industry is not insulated from macroeconomic events and financial shocks, as evidenced by the well-documented failures of Arcapita, East Cameron *Şukūk* and Ihlas Finans House.

The Islamic Financial Services Board has produced two previous working papers on the theme of financial safety nets – namely, on Sharīʿah-compliant lender-of-last-resort and Sharīʿah-compliant deposit insurance schemes. This working paper is the final in the series and focuses on recovery and resolution planning and insolvency issues for institutions offering Islamic financial services (IIFS).

The Islamic finance industry has grown to almost USD 2 trillion in assets globally, and Islamic bank assets have become systemically important (>15% of total bank assets) over 12 jurisdictions. A number of IIFS have also become significantly large and reached domestic systemically important bank status. It is paramount, therefore, that jurisdictions have in place effective recovery and resolution frameworks that are cognisant of the structural, legal and operational nuances of relevant Sharīʿah principles.

This paper begins by examining what an effective recovery and resolution framework looks like. The starting point is the Financial Stability Board’s *Key Attributes of Effective Resolution Regimes for Financial Institutions* (“Key Attributes”). This 2014 publication emphasises the importance of an appointed resolution authority, consolidating within it specific regulatory powers and tools. There is ongoing discussion as to who this authority should be, the role being taken up in many jurisdictions by the central bank. The current trend seems to be a shift towards having national deposit insurance providers take the lead. For dual jurisdictions (those containing both conventional and Islamic banks), it is likely that the resolution authority will be responsible for both sectors. It is key, therefore, that the authority either has in-built Sharīʿah expertise, or has access to duly appointed Sharīʿah experts, when carrying out crisis planning and during the actual process of recovery and resolution. This is to ensure that the Sharīʿah and operational issues discussed later can be managed appropriately.

Examining the European and US regulatory landscape further, we find that recovery and resolution planning is a key aspect of the wider framework. Banks are required to carry out a self-assessment (linked to the results of their own stress testing) as to what feasible recovery options (liquidity and capital) they can execute during a stress scenario, with quantified

measurements regarding haircuts and expected inflows/outflows. From a resolution perspective, banks will again self-assess what the best mode of resolution is for them, such as a solvent wind-down/asset transfer, should it be required.

Recovery and resolution planning, and the “pack” that is produced at the end of the process, enables a bank to have a set plan in place that can be executed with a reasonable amount of accuracy during a crisis. The various options, such as asset sales, intragroup support and central bank facilities, are designed to help the entity recover and to prevent it from becoming insolvent. Identifying such options during a business-as-usual period, with identified internal responsibility and trigger points, allows a bank to be prepared should a stress event take place. This paper examines in detail the various recovery options that would be available to an Islamic bank, and analyses the structural and operational issues that a recovery and resolution framework would need to take into account.

Chapter 3 of the paper begins by establishing the Sharīʿah principles of *iflās* (insolvency). Importantly, *iflās* requires declaration by an authority; it cannot simply be voluntary and completely unilateral. The general Sharīʿah principles around payment of debt are stringent, in that debt cannot simply be written off. It must be paid in full unless there is specific debt forgiveness by the creditor (whether partial or whole). Sharīʿah also, however, promotes the act of giving time to a debtor, or ultimately forgiving their debts, as the ethically superior thing to do where the debtor ultimately cannot pay. The general *maqāṣid al-Sharīʿah* in the context of corporate insolvency seems to be that helping an entity recover and move back to functioning as a going concern (if it has become insolvent) is preferred. The analysis and the case studies, particularly with regards to restructuring, should be read in this light.

Chapter 3 goes on to analyse various recovery and resolution options, and some of the Sharīʿah and operational issues that arise. Data on the Islamic finance industry indicate that a vast majority of Islamic bank assets are debt in nature (*murābaḥah*). Sale of debt at less than par is not permitted under Sharīʿah; however, asset sales during a stress event will always be at a haircut given how normal financial markets operate. Intragroup liquidity injections may need to be done in a Sharīʿah-compliant structure, and central bank facilities that are Sharīʿah-compliant only exist in a handful of jurisdictions. Similarly, there may be issues with bail-in (writing down an institution’s debt or partially converting that debt into equity) when debt structures have been used for capital (i.e. *murābaḥah*). With regards to bridge banks and asset transfers, it could be feasible that, in a particular jurisdiction, all the IIFS are in the midst of a similar stress event and it simply may not be possible to sell assets, or to transfer them to another Sharīʿah-compliant entity. Opening up sales and transfers to other market players (such as conventional asset managers for profit-sharing investment accounts) could be an

option; however, further thinking is required to ensure that ongoing Sharī'ah governance and compliance is maintained.

The paper's analysis shows that a recovery and resolution framework for Islamic finance must be cognisant of a number of specificities, many of which do not create any particular challenge in the conventional market. The aim of the paper in this section has been to bring these challenges to the surface and make policymakers and regulatory authorities aware of their implications. As the previous chapter's analysis has shown, recovery and resolution is about pre-planning and ensuring that a stress event can be dealt with when it actually occurs. Various structural and legal issues flaring up during a crisis would undoubtedly result in firm failure. Sharī'ah thinking around stressed market conditions, and what can be done by banks to recover themselves (which is preferable to going insolvent), needs further development. The most important take-away from this section would be to engage Sharī'ah experts early in the process of creating a recovery and resolution framework specifically for Islamic finance. There may be flexibility in business, as the usual Sharī'ah norms help a failing bank to save itself. (As mentioned previously, this is in line with the *maqāṣid al-Sharī'ah*.)

The chapter also explores some of the structural issues that can arise in capital-qualifying *ṣukūk* given Sharī'ah creditor hierarchies. In particular, many current Additional Tier 1 *ṣukūk* use *muḍārabah* or *wakālah* contracts; however, the structures are coterminous with *mushārah*. From a permanency and loss absorbency perspective, as per Basel, there are no issues; however, a strict interpretation of Sharī'ah may require *mushārah*-like investors to bear the same risks at default as shareholders. Given that the market has now moved towards contingent convertible structures for Tier 1 and Tier 2 instruments, *muḍārabah* and *wakālah ṣukūk* may lend itself to the trend, given that it is already equity in principle. The chapter touches on insolvency issues in *takāful*, looking at the difficulties with *qarḍ* subordination. It recommends a more banking-based capital approach (as per IFSB-15), which essentially views the whole *takāful* undertaking (operator and all funds) as one legal entity.

A survey of regulatory authorities was also carried out as part of this research paper, the findings of which are detailed in Chapter 4. A total of 22 respondents from 16 jurisdictions answered the questionnaire, which sought to understand what the current regulatory framework on recovery and resolution looked like in markets with Islamic banks. A majority of respondents confirmed that one sole institution was responsible for the resolution of both Islamic and conventional banks. A majority also confirmed that RRP packs were required to be produced by their banks with quantified capital and liquidity recovery options and specified trigger points. The results indicate that while the general framework exists, and resolution

authorities tend to possess most of the powers indicated by the Financial Stability Board, these frameworks are built for conventional banks. Specific thinking, as detailed in this paper, is needed in order to adapt or extend the frameworks for Islamic banks. The survey also indicates that Sharī'ah-compliant lender-of-last-resort and deposit insurance schemes are few and far between globally. While it is encouraged for policymakers to create such mechanisms in their own jurisdictions, this paper urges all Islamic banks, along with their Sharī'ah boards, to consider using (if they are not already being used) the local lender-of-last-resort and deposit insurance scheme facilities to ensure financial stability. Until Sharī'ah alternatives exist, such schemes are also integral to safety nets in any financial system.

The paper considers one case study in its penultimate chapter. The collapse of Ihlal Finans House, which was not a bank at that time, is an older case from the turn of the millennium. While the Turkish regulatory system has come a long way since then in terms of specific Islamic finance initiatives and frameworks, the case demonstrates two important things. First, liquidity crises are usually the biggest and most dangerous cause of banking failures. Islamic financial institutions are prone to the same types of liquidity runs that we see with conventional banks, particularly as regards the retail deposit book. Given that liquidity is an ongoing structural issue for the Islamic finance industry, it is an area that this paper urges policymakers and regulators to focus on specifically with regards to recovery and resolution. Second, a lack of other financial safety nets (lender of last resort and deposit insurance schemes) and proper recovery and resolution planning can quickly cause a financial institution to go into failure. The case shows how a lack of any real pre-planning results in on-the-spot decision making by senior management during a crisis. Without a well-thought-out plan of action, it is highly unlikely that any financial institution can survive such a stress scenario.

In conclusion, this paper and the research conducted by the Islamic Financial Services Board have sought to bring to light many of the complex issues that the Islamic finance model brings to conventional practices of recovery and resolution. The paper establishes, first, what a robust framework looks like, and then applies it to Islamic finance entities. The discussion of issues is intended to enable further consideration by policymakers and regulators, together with Sharī'ah scholars and boards. Pre-planning is key to successful recovery; unless these issues are dealt with early, the results can be catastrophic should a severe financial stress event take place.

CHAPTER 1: BACKGROUND AND OBJECTIVES

1.1 Background

A number of banking and financial institution crises occurred after the collapse of the Bretton-Woods system in the 1970s. These included the Latin America debt crisis (1980s) and the Asian financial crisis (1997–8). Financial safety nets – namely, lender-of-last-resort (LOLR) facilities and deposit insurance schemes (DIS) – garnered the attention of policymakers and regulatory bodies as a result of these periods of volatility.

The global financial crisis (GFC) (2007–8) and the subsequent high-profile collapse of banks and financial institutions, such as Bear Stearns and Lehman Brothers (US), Kaupthing (Iceland) and the liquidity crisis faced by Northern Rock (UK), shifted the regulatory focus onto another safety net – namely, recovery and resolution. The financial contagion caused by the collapse of a banking or other financial institution can have serious and prolonged ramifications for the wider economy. The impact of the GFC is still being felt globally a decade on. The systemic importance of banks and other financial institutions, which can lead to issues of moral hazard with regards to financial safety nets, is a key focus area for the global regulatory framework.

The aim of recovery and resolution planning is to enable banks and other financial institutions to restore viability through their own actions, prior to the need for a regulatory authority intervention to enforce specific recovery and/or wind-down powers.² Recovery includes recapitalisation and other reorganisation and restructuring concepts that are included in “bankruptcy” (as opposed to pure “insolvency” regimes³). The resolution aspect of the framework is for authorities to be able to plan how best to stabilise or wind down a firm that is no longer viable or is likely to become non-viable (as per the Financial Stability Board’s Key Attributes) while ensuring minimal disruption to the wider financial system. A key principle underlying the global recovery and resolution framework is to address the “too big to fail” moral

² Financial Stability Board (2012). *Recovery and Resolution Planning: Making the Key Attributes Requirements Operational* (November).

³ Insolvency occurs when a legal entity can no longer meet its obligations, or when its liabilities exceed its assets. In secular law, bankruptcy is proceeding for the restructuring of the debtor and the debtor’s liabilities. Under the Shari’ah, bankruptcy is, ultimately, a legal status, declared by a requisite authority following self- or creditor application, although in contemporary practice it also includes the bankruptcy restructuring process. For purposes of this paper, references are made to the bankruptcy process, including Chapter 11 of the US bankruptcy laws. It should be noted that this is for purposes of discussing principles that are applied in a bankruptcy (including restructuring) proceeding. It should be further noted that distressed, failing and insolvent national banks in the United States come under the receivership powers of the Federal Deposit Insurance Corporation and not under the jurisdiction of the bankruptcy courts applying Chapter 11. (State banks are subject to receiverships under applicable state laws.)

dilemma – that is, maintaining financial stability while allowing banks and other financial institutions to fail as per the risks of doing business.

Moral hazard as a result of critical functions carried out by a bank or financial institution, or merely due to the size of the entity, will vary from jurisdiction to jurisdiction. While this working paper is focused more on banking entities from a recovery and resolution perspective, exactly which entities fall into a recovery and resolution framework is a country-by-country determination.

The Islamic financial services industry (IFSI) has reached an overall value of USD 1.88 trillion as of year-end 2015.⁴ It is of systemic importance in 12 jurisdictions,⁵ and a number of Islamic banks and financial institutions are domestically significant. The general economic environment in which the IFSI is growing is challenging, with geopolitical conflicts, energy price downturns and emerging market volatility being observed over the last 24 months. Institutions offering Islamic financial services (IIFS) are not insulated from stress and failure. Well-known cases such as the bankruptcies of the East Cameron Şukūk and Arcapita are evidence that the IFSI must also be cognisant of recovery, resolution, and bankruptcy and insolvency matters.

The Islamic Financial Services Board (IFSB) stressed the need for financial safety-net arrangements in the IFSI in April 2010 when, in partnership with the Islamic Research and Training Institute (IRTI) and the Islamic Development Bank (IDB), a report was released entitled *Islamic Finance and Global Financial Stability*. This report, which was prepared under the guidance of the Task Force on Islamic Finance and Global Financial Stability, headed by H.E. Dr. Zeti Akhtar Aziz (former Governor, Bank Negara Malaysia), identified eight building blocks aimed at further strengthening the Islamic financial infrastructure at the national and international levels to promote a resilient and efficient Islamic financial system. Among these eight building blocks, the third relates to the strengthening of the financial safety-net mechanism comprising a Sharī'ah-compliant lender-of-last-resort facility (SLOLR), as well as a Sharī'ah-compliant deposit insurance scheme (SCDIS). Both of these safety nets have been addressed by the IFSB in previous working papers.⁶ The IFSB and the World Bank have also jointly conducted a roundtable discussion on effective bankruptcy and insolvency regimes for the IFSI (2010).

⁴ Islamic Financial Services Board, *IFSI Stability Report 2017*.

⁵ The criterion for Islamic banking's systemic importance is when total Islamic banking assets in a country comprise more than 15% of its total domestic banking sector assets.

⁶ IFSB, WP-01/04/2014: *Strengthening the Financial Safety Net: The Role of Sharī'ah-compliant Lender of Last Resort Facilities as an Emergency Financing Mechanism*; and IFSB, WP-06/03/2016: *Strengthening the Financial Safety Net: The Role and Mechanisms of Sharī'ah-compliant Deposit Insurance Schemes*.

The *Islamic Finance and Global Financial Stability Report* considers effective crisis management (including recovery and recapitalisation of failing entities) and resolution frameworks as the fourth building block of Islamic financial infrastructure. The challenge of adapting existing regulatory frameworks to Sharī'ah principles and requirements, or of developing new ones in this area, is noted in the report, and is a key consideration throughout this paper. This working paper is the final of the IFSB's series of papers on financial safety nets.

The formulation and implementation of a well-designed recovery and resolution regime is particularly challenging for the IFSI given the specificities of Sharī'ah contracts and principles that affect capital and liquidity recovery options, as well as the powers and tools available to a resolution authority. Key bankruptcy and insolvency issues such as creditor hierarchies and the treatment of funds of investment account holders (IAH) are also areas that require thinking with regards to accepted legal norms and Sharī'ah considerations. Ensuring Sharī'ah compliance at the point of failure, and maintaining the rights and remedies offered by Sharī'ah against an established juridical framework, are challenges this paper seeks to address. The objectives and scope of the paper are highlighted in the following subsection.

1.2 Objectives and Scope

Taking into context the above background, this working paper examines the role and significance of recovery, resolution and bankruptcy/insolvency for the stability and resilience of the IFSI and various structural issues for regulatory authorities to consider when creating their own frameworks. The key objectives of the working paper are as follows:

- (a) to review the requirements of a robust recovery and resolution framework through literature review and jurisdictional analysis;
- (b) to consider and analyse key recovery, resolution and bankruptcy principles in the context of Islamic finance industry practices and Sharī'ah requirements; and
- (c) to indicate specific issues that require further consideration by regulatory authorities/policymakers and IIFS regarding recovery, resolution and bankruptcy.

The scope of the paper is cross-sectoral and considers Islamic banking, capital markets and *takāful*. With regards to capital markets, the paper remains focused on recovery, resolution and bankruptcy/insolvency issues as they pertain to *ṣukūk* and relates them back to the banking sector in the context of capital-qualifying components. The IFSI is estimated to be 80%⁷ concentrated in Islamic banking, and this paper focuses mainly on that sector. The IFSB

⁷ As per the IFSB's *Stability Report 2017*, total Islamic bank assets are approximately USD 1.5 trillion. (*ṣukūk* outstanding volume is approximately USD 319 billion.)

has carried out a members' regulatory and supervisory authority (RSA) survey as part of this working paper, and is grateful to the respondents for their constructive questions and comments. The information provided in the responses gives a better understanding of where jurisdictions currently stand with regards to recovery and resolution framework development. The survey questions focused on recovery and resolution powers and tools, as well as establishing the legal environment in each member state.

The working paper can serve as initial guidance to RSAs to assist in their recovery, resolution and bankruptcy/insolvency framework development as it pertains to IIFS. By conducting an extensive literature review on recovery, resolution and bankruptcy/insolvency frameworks with a focus on the latest approaches taken by the global standard-setting and supervisory community, as well as by considering the practical application of these approaches in the context of Islamic finance structures and Shari'ah principles, the working paper endeavours to enhance knowledge in this subject area.⁸ The following subsection provides the structural breakdown of the paper.

1.3 Structure of the Working Paper

Having framed the background to this study and set out the working paper's objectives and scope, we now consider its structure, as follows:

- Chapter 2 begins the literature review on the conceptual framework for recovery, resolution and bankruptcy/insolvency. It considers regulatory best practices and requirements from global standard-setting bodies, including the Financial Stability Board (FSB) and the European Central Bank (ECB). It also provides jurisdictional analysis with regards to established recovery, resolution and bankruptcy/insolvency frameworks.
- Chapter 3 continues to review the literature and applies the conceptual framework established in Chapter 2 to the IFSI (cross-sectoral). It considers specific recovery options, resolution tools, and bankruptcy/insolvency issues in the context of Islamic finance structures and Shari'ah principles. It highlights some of the key practical considerations for policymakers and RSAs when developing a framework for their Islamic industry.

⁸ The paper's starting point is in establishing the conceptual framework of recovery, resolution and bankruptcy/insolvency. The analysis of and discussion around applying such frameworks and tools within the IFSI, and consideration of the issues that arise, are aimed also at offering RSAs and IIFS practical guidance on establishing and operationalising such frameworks.

- Chapter 4 provides a detailed analysis of the IFSB's survey of member RSAs (2016) with regards to recovery, resolution and bankruptcy/insolvency frameworks. It highlights the recovery and resolution powers and tools currently available to authorities across a number of jurisdictions. It considers the current state of recovery and resolution frameworks and the bankruptcy/insolvency legal landscape.
- Chapter 5 details one case study of actual IIFS insolvency and restructuring from Turkey. It also considers this case in the context of Sharī'ah *iflās* principles and issues of recovery, resolution and restructuring.
- Chapter 6 provides concluding remarks on this study and highlights the key challenges that need to be considered by RSAs and policymakers when establishing a recovery, resolution and bankruptcy/insolvency framework for their IFSI.

CHAPTER 2: REVIEW OF LITERATURE AND GUIDELINES ON RECOVERY, RESOLUTION AND INSOLVENCY

2.1 Framework

On 15 September 2008, Lehman Brothers filed for bankruptcy protection following the sub-prime-mortgage-induced Global Financial Crisis. Similarly, other mortgage-related bankruptcies and foreclosures on a massive scale as a result of the housing bust in the United States rendered many financial institutions illiquid and/or insolvent. Although the US government's support to some "too big to fail" financial institutions was intended to avoid further collapse and to restore public confidence, the sharp rise in credit risk and the sudden decrease of the capital base of the financial institutions resulted in a pervasive credit squeeze and interbank lending failures. The immediate solvency measures, such as the government's bail-outs, were not entirely successful in restoring consumer and business confidence, and consumption and investment activities continued to decline. Though the crisis was centred in the US, the contagious effects spread around the globe and their implications for the roles of monetary and fiscal authorities were, and continue to be, far reaching.

Following these events, the G-20 leaders rightly emphasised the need for stringent regulation of financial institutions and took the initiative by establishing the Financial Stability Board as the successor to the Financial Stability Forum with a broader mandate of promoting financial stability. In 2014, the FSB developed the *Key Attributes of Effective Resolution Regimes for Financial Institutions*, which set down core elements of recovery and resolution planning for financial institutions.

This section discusses the need for financial institutions to have an effective recovery and resolution framework, and the legal and operational capacities the resolution authority should possess. Why do government interventions need to be institutionalised in a set of regulations that force the relevant authorities to comply with reporting and decision-making processes? An example of one set of answers is Glaessner and Mas (1995),⁹ who argue that resolution of bank crises is often paralysed when regulatory discretion is applied, and that regulators and insurers tend to avoid taking responsibility for closing down an insolvent bank. The following discussion highlights the development of recovery and resolution programmes (RRPs) as initiatives taken by international and national bodies in the financial sector.

2.1.1 FSB's Key Attributes on Recovery and Resolution Programmes

⁹ T. Glaessner and I. Mas (1995). Incentives and the Resolution of Bank Distress, *The World Bank Research Observer*, 10(1), 53–73.

The Key Attributes (KA) framework refers to the RSAs' and individual financial institutions' need to ensure that the firms (financial institutions) for which an RRP is required maintain a recovery plan (KA 11.5) that identifies options for restoring financial strength and viability when the firm comes under severe stress. In this way, the RRP can equip RSAs and financial institutions with better tools and funding options to minimise the need for public funding should another financial crisis hit. To cope with any crisis, an adequate and credible recovery and resolution plan is suggested. That plan should be responsive to both idiosyncratic and market-wide stresses. The Key Attributes recommend different types of timely implementation of recovery options in a range of stress situations. The FSB's position is that the regulatory regime can be extended to: (a) holding companies of a firm; (b) non-regulated operational entities within a financial group; and (c) branches of foreign firms.

Assessing capital shortfalls and liquidity pressures, for example, in a proper way, are two key requirements (from the points of view of both idiosyncratic and market-wide stress) for preparing an effective, viable and realistic recovery and resolution option. Therefore, the recovery and resolution plan developed by a financial institution under an agreement with the relevant regulatory authority should demonstrate the ability of the institution to recover its capital and liquidity positions in a stress scenario. Though the required criteria the FSB provided are mainly for global systemically important financial institutions (G-SIFIs), the FSB's recommended procedures for identifying qualitative and quantitative criteria may fit the implementation of the plan by any financial institution. The FSB recommends that each individual G-SIFI is required to develop its own stress scenarios. Moreover, the supervisory authorities should also determine a firm-specific minimum total loss-absorbing capacity (TLAC) requirement for each G-SIB, considering their systemic footprint, business model, risk profile and organisational structure.

The FSB (2015)¹⁰ sets out three principles for determining firm-specific requirements for each G-SIB: (i) the firm-specific minimum TLAC requirement should be at least equal to the common minimum agreed by the FSB; (ii) the supervisory authorities should consider appropriately prudent assumptions about prospective losses prior to resolution, as well as losses during revaluation of assets; and (iii) the institution or successor institution (e.g. bridge institution) must meet the condition for authorisation, including any consolidated capital requirements, and be sufficiently well capitalised to ensure continuity of critical transactions.

¹⁰ Financial Stability Board (2015). *Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution – Total Loss-absorbing Capacity (TLAC) Term Sheet*.

In line with the FSB's attributes, the G-SIBs use both quantitative and qualitative triggers in their recovery plans. The range of possible quantitative triggers as mentioned by FSB (2013)¹¹ could focus on the change elements, such as:

- rating downgrades;
- revenue reports or profit and loss (or components of these);
- credit risk limits;
- equity ratios;
- percent renewal of wholesale financing;
- withdrawal of deposits and other funding;
- increased collateral requirements;
- market-based leverage ratios;
- a three-month interbank rate; and
- senior debt and subordinated debt spread.

Though qualitative triggers are important, at present their use is significantly less widespread than quantitative triggers. Counterparty risk is a consideration for qualitative risks, where different indicators are monitored to signal a potential counterparty risk event. Qualitative triggers might include:

- requests from counterparties for early redemption of liabilities;
- difficulties in issuing liabilities at the current price;
- a sudden loss of senior management;
- a court ruling that affects the financial institution;
- negative market pressure; and
- reputational degradation.

The trigger points as recommended by the FSB are basically to encourage financial institutions to introduce an appropriate framework of recovery options that addresses both idiosyncratic and market-wide stresses at the national level. Such trigger points of financial institutions, if agreed by a competent authority, provide scope to a proper assessment framework. The assessment framework should include the powers that competent authorities may exercise.

The recovery and resolution reform mentioned in the FSB's Key Attributes is intended to allow feasible resolution of financial institutions without severe systemic disruption and without exposing taxpayers to loss. These kinds of resolution measures protect critical economic

¹¹ Financial Stability Board (2013). *Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Recovery Triggers and Stress Scenarios*.

functions through mechanisms in such a way that shareholders and unsecured and uninsured creditors can absorb losses in respect to the hierarchy of claims in liquidation. Therefore, to be recoverable, an institution should satisfy three basic conditions: (A) the institution, through its own recovery options, can be easily recapitalised without imposing burdens on taxpayers; (B) the institution in recovery can continue its regular business activities and transactions with customers; and (C) the overall financial markets and the economy at large would not be affected by the institution in recovery.

A designated administrative authority or authorities should be responsible for exercising the recovery and resolution powers over the firms mentioned above. In the case of multiple resolution authorities, the FSB recommends that mandates, roles and responsibilities of the respective authorities should be clearly defined and coordinated.

The implementation of bail-in should not trigger cross-default clauses in customer obligations, such as derivatives or repurchase agreements. The immediate bail-in of investor obligations should effectively recapitalise the bank or other financial institution so as to provide sufficient immediate protection to counterparties.

Huertas (2013)¹² identified some critical considerations that are applicable in the context of a smooth recapitalisation of a financial institution without recourse to taxpayers' money. The author mentions that the total of "investor" instruments subject to immediate bail-in (non-core Tier 1 capital, Tier II and senior debt subject to bail-in) should be at least equal to the required common equity Tier 1 capital so that the immediate bail-in would effectively recapitalise the bank, even if the entire amount of common equity Tier 1 capital had to be written off. The resolution authority should have powers under relevant laws and contractual powers to execute the bail-in of investor instruments immediately. The author also argues that the implementation of an immediate bail-in of investor obligations should effectively recapitalise the bank so as to provide sufficient immediate protection to counterparties.

There should be a clear distinction between customer obligations, such as deposits and derivatives, and investor obligations, such as senior debt. Similarly, to allow uninterrupted continuation of business on the business day following the initiation of the recovery and resolution process: (1) an immediate authorisation should be provided to the bank-in-resolution to operate as a financial institution, and the resolution authority should have the power to continue the operations of the bank-in-resolution; (2) the bank-in-resolution should continue service-level agreements with suppliers (including other affiliates in the banking group) even if the bank enters resolution; (3) the bank-in-resolution should have continuing

¹² T. F. Huertas (2013). Safe to Fail, *Butterworths Journal of International Banking & Financial Law*, 28(7), 407–11.

and uninterrupted access to financial market infrastructures, such as payment systems, securities settlement systems and central counterparties; and (4) the bank-in-resolution should have access to adequate liquidity, particularly from the central bank or resolution authority.

However, the author notes that the resolution authority's liquidity facility should be secured by sound collateral. To minimise the possibility that the resolution process might disrupt financial markets or the economy at large, the resolution process should come as a result of well-advertised resolution planning. Moreover, the author explains that the recovery and resolution process should be designed and implemented to avoid fire-sales of assets in order to avoid any knock-on effect on the market as a whole. In addition, the recovery and resolution process should not interrupt clients' access to their assets. Finally, the recovery and resolution process should leave financial market infrastructures intact and able to continue to fulfil their functions.

Therefore, a recovery and resolution plan contains a series of clear and predefined options that will be executed by a financial institution in the face of financial stress. The plan should be integrated into the financial institution's existing governance framework and processes. It should include regular monitoring of early warning signs and predefined triggers to identify the necessary actions, and regular reviews and updates. Moreover, the plan should be overseen and approved by the board of directors or a senior management committee before implementation commences (PricewaterhouseCoopers, 2015).¹³

The FSB's Key Attributes framework recommends that resolution authorities have operational independence and unimpeded access to financial institutions. The general resolution powers of the resolution authorities highlighted by the Key Attributes (KA 3.2) are their abilities to:

- remove and replace the senior management and directors and recover monies from the responsible persons;
- appoint an administrator to take control of and manage the affected firm;
- operate and resolve the firm, including powers to terminate contracts, continue or assign contracts, purchase or sell assets, and write down debt;
- ensure continuity of essential services and functions by requiring other companies in the same group to continue to provide essential services to the entity in resolution, any successor or an acquiring entity;
- override rights of shareholders of the firm in resolution;
- transfer or sell assets and liabilities, legal rights and obligations to a solvent party;
- establish a temporary bridge institution to take over and continue operating certain

¹³ PricewaterhouseCoopers (2015). *Recovery & Resolution Planning: A Malaysian Disclosure*.

- critical functions and viable operations of a failed firm;
- establish a separate asset management vehicle;
- conduct bail-ins as a means to achieve, or help achieve, continuity of essential functions;
- temporarily stay the exercise of early termination rights;
- impose a moratorium with a suspension of payments to unsecured creditors and customers; and
- effect the closure and orderly wind-down of the institution.

2.1.2 BCBS Guidelines for Recovery and Resolution Programmes

The Basel Committee on Banking Supervision (BCBS) (2012) explains recovery and resolution programmes and describes the roles of regulators. The BCBS highlights the need for a clear framework for crisis management and recovery, and resolution programmes are mentioned as one of the preconditions for effective banking supervision. The BCBS focuses on requirements for a clear mandate and an effective legal underpinning for each relevant authority as the basis for a sound institutional framework for crisis management and resolution. The mandate and legal framework include a broad range of powers and appropriate tools that the relevant regulatory authorities can exercise for their financial institutions if the institutions are likely to fail. In this respect, the BCBS also recommends that an agreement is required among relevant authorities (such as banking supervisors, national resolution authorities, finance ministries and central banks) on their individual and joint responsibilities for preparing recovery and resolution options for the institution, and how they will implement these responsibilities in a coordinated manner. The agreement also refers to sharing confidential information to facilitate proper planning for the options.

2.1.3 Recovery and Resolution Programmes for European Union (EU) Member States

The recent high-profile banking crises involving Fortis, Lehman Brothers, Icelandic banks, Anglo Irish Bank, and Dexia induced the European Commission¹⁴ to introduce recovery and resolution plans for its banking sector. Supporting those banks deemed too big to fail became increasingly unsustainable. To enhance long-term financial stability and reduce public costs associated with a possible future financial crisis, the EU crisis management framework

¹⁴ The International Monetary Fund (IMF) estimates that European banks incurred losses during the financial crisis of close to € 1 trillion, or 8% of the EU gross domestic product (GDP) between 2007 and 2010. The Commission approved € 4.5 trillion, or 37% of EU GDP, between October 2008 and October 2011, as state aid measures to financial institutions (Memo: 'Bank recovery and resolution proposal: Frequently Asked Questions', 6 June 2012, European Commission).

suggests both comprehensive and effective arrangements for dealing with failing banks at the national level, as well as to tackle cross-border banking failures.

The European Commission (2012),¹⁵ in its Commission Staff Working Document on impact assessment, also recommends the development of adequate tools at the national level for dealing speedily with unsound and failing credit institutions and investment firms, with minimal risk to financial stability. The proposal recommends that, in contrast to customary insolvency procedures, a special recovery and resolution procedure for banks and other financial institutions should be developed to provide authorities with a set of tools (e.g. sale of the business, asset separation, bridge bank and bail-in) that are more suited to the needs of banking and financial businesses. The recovery and resolution tools allow a more appropriate balancing of priorities among shareholders, depositors and investors. The proposal also recommends that large, complex and interdependent financial institutions need to introduce a supplementary mechanism that enables each institution's debt to be written down or partially converted into equity ("bail-in") in a way that protects financial stability and taxpayers' money. The proposal suggests that the resolution authorities should have powers to take action before a bank or financial institution is economically insolvent, in order to increase the realistic chances of successful and effective recovery or resolution. In this regard, the resolution authority will prepare a recovery or resolution plan for an institution (at the entity and group level) setting out options for recovering or resolving the institution in different scenarios, including systemic instability. Supervisory authorities should have powers to intervene early in an insolvent financial institution to implement recovery and resolution plan measures or to remove or replace management if needed.

Therefore, the recovery and resolution plans are strong elements of discipline for the European markets; that is, they are intended to make banks stronger, with higher levels of better-quality capital, greater protection of depositors, safer and more transparent market structures and practices, and better supervision. The key elements of the framework recommended by the ECB are based on: (a) prevention and preparation; (b) early intervention; (c) credible resolution tools; and (d) cooperation between national authorities.

In line with the FSB framework of Key Attributes, the European Banking Authority (EBA) published a consultative document on technical standards and guidelines for RRP in July 2014, taking into account the FSB's Key Attributes and current supervisory practices. The first set of technical standards mentioned in the consultative document specifies the information

¹⁵ European Commission (2012). Commission Staff Working Document. Summary of the Impact Assessment. Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending *Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No. 1093/2010.*

that institutions should include in their RRP, as follows: (i) a summary of the RRP; (ii) information on governance; (iii) a strategic analysis; (iv) a communication plan; and (v) a description of preparatory measures. The second set of standards in the document identifies the principles and criteria that supervisory authorities shall follow when assessing (A) the completeness, (B) the quality, and (C) the credibility of RRP. The recovery and resolution framework requires credit institutions and investment firms to plan in advance in order to strengthen their ability to restore financial and economic abilities and functioning in situations involving severe stress.

The EBA's standards broadly classify stress scenarios into two categories for the RRP of financial institutions. They are: (1) "system-wide events", meaning events that risk having serious negative consequences for the financial system or the real economy; and (2) "idiosyncratic events", meaning events that risk having serious negative consequences for a single institution, a single group, or an institution within a group. The range of scenarios of financial distress involving an institution or a group may constitute a system-wide event or an idiosyncratic event, or a combination when both occur simultaneously or interactively. The concerned institution or group would then assess the impact of the events on at least each of the following aspects:

- available capital;
- available liquidity;
- business model;
- profitability;
- payment and settlement operations; and
- reputation.

The EBA also launched a consultation document on draft guidelines for RRP indicators. The consultation document suggests minimum qualitative and quantitative indicators that institutions should include in their RRP. The standards mention that institutions should include in their RRP at least the following categories of indicators:

- capital;
- liquidity;
- profitability; and
- asset quality.

The guidelines also identify market-based and macroeconomic indicators that institutions should include if relevant to their legal structure, risk profile, size and complexity.

After a series of proposals and consultations, the European Union provided in 2014 the Bank Recovery and Resolution Directive (BRRD) of the European Parliament and of the Council to deal with the financial institutions and investment firms in EU member states.¹⁶ The Directive stated that EU member states were required to comply with the laws, regulations and administrative provisions by 31 December 2014, and to apply the Directive's measures and procedures at the latest by 1 January 2015. Each institution subject to the Directive was required to maintain a recovery plan that detailed its quantitative and qualitative measures. The measures were to be monitored by a competent authority (CA) responsible for the prudential supervision of institutions. The member states should also appoint a resolution authority (RA) to review the recovery plan of individual institutions and provide its own recommendations to the CA. The member states could also designate their supervisory authority (competent authority) as a resolution authority with adequate structural arrangements that separate the supervisory and resolution functions. In line with the recovery plan, the CA was given the power to enhance timely recapitalisation measures as well as to reduce risk profiles of the institutions if they were likely to fail. The CA also reviewed each institution's strategy and structure, including funding strategy and governance structure, so as to improve the stability of its operations. If an institution was deemed to be allowed to fail, it was feasible for the RA to liquidate it under normal solvency proceedings or to resolve the matter in such a way as to minimise any adverse effect on the financial system.

Under the BRRD on crisis prevention, management and resolution of financial institutions, the EBA is mandated to develop technical standards, guidelines and reports with the aim of ensuring effective and consistent procedures across the Union. A recent consultation¹⁷ launched by the EBA provides a recommendation on the coverage of entities in banking group recovery plans aimed at defining common criteria to identify entities, including subsidiaries and branches. The draft recommends that the coverage of entities in a group recovery plan needs to be in proportion to the relevance of the entities, categorising them as: (a) relevant for the group; (b) relevant for the economy or financial system of a relevant member state; or (c) not relevant for either of the two. Moreover, the EBA published a comparative report¹⁸ on recovery planning, with the main focus of comparative analysis being recovery options, which are crucial for assessing institutions' actual capacity to regain viability following a period of severe financial

¹⁶ Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014, establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council.

¹⁷ European Banking Authority (2017). *Recommendations on the Coverage of Entities in a Group Recovery Plan*, Consultation Paper, EBA/CP/2017/03.

¹⁸ European Banking Authority (2017). *EBA Recovery Planning – Comparative Report on Recovery Options* (1 March 2017).

distress. The analysis found good progress already made so far in the vast majority of cases of those banks that had detailed options in their recovery plans. However, there is still scope for improvement and further developments. Therefore, the recovery plan needs to be effective, providing a good range of recovery options that could restore the viability of the bank or the group in a situation of financial distress.

2.1.4 Dodd-Frank Act

In the US, the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (“the Dodd-Frank Act” (2010))¹⁹ has established a recovery and resolution framework for systemically important financial institutions. The US approach intends to address systemic banks and financial institutions by taking failing banks or institutions into receivership by the Federal Deposit Insurance Corporation (FDIC), under which their business will be transferred to a new entity or be wound down. The stated aim of the Dodd-Frank Act is to promote the financial stability of the United States by improving accountability and transparency in the financial system, to reduce or eliminate “too big to fail” concepts, to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and to fulfil other purposes.

Two new agencies, the Financial Stability Oversight Council (FSOC) and the Office of Financial Research (OFR) in the Treasury Department, are assigned the responsibility –under Title I of the Dodd-Frank Act – to monitor systemic risk in respect to the overall economy. The Dodd-Frank Act clarifies the need for comprehensive supervision of bank holding companies by the Board of Governors of the Federal Reserve System of the United States. Under the Dodd-Frank Act, the Fed is required to establish prudent standards for systemically significant financial institutions that are subject to more stringent risk-based and contingent capital requirements, leverage limits, liquidity requirements, resolution plan and credit exposure report requirements, concentration limits, disclosure rules, short-term debt limits, and overall risk management requirements.

The FSOC is a committee comprised of members from regulatory bodies. It primarily identifies financial institutions, including banks, in terms of systemic importance. The FSOC also serves to advise existing regulatory bodies for systemic foreign bank subsidiaries on what possible measures could be taken to mitigate risks. The Board of Governors and the FSOC determine whatever heightened requirements on capital and liquidity should be imposed on a systemic foreign bank considering Basel III standards as a basis upon which to settle. Title I also

¹⁹ *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub. L. No. 111-203, 124 Stat. 1376 (2010), as amended.

introduces a “living will” requirement, which refers to a second guaranteed requirement placed upon a SIFI identified by the FSOC.

The living will is a rapid dissolution plan required to be maintained by the foreign bank if identified as systemically important. Since each systemically important foreign bank will undergo annual stress tests conducted by the Board of Governors, this living will is treated as a second guaranteed requirement. Essentially, the Board of Governors also requires each non-bank financial company supervised by the Board of Governors and bank holding companies to report periodically to the Board of Governors, FSOC and the FDIC with respect to the living will of such company for rapid and orderly resolution in the event of material financial distress or failure. The living will shall include: (a) information regarding the manner and extent to which any insured depository institution affiliated with the bank holding company is adequately protected from risks arising from the activities of any non-banking subsidiaries of the company; (b) full descriptions of the ownership structure, assets, liabilities and contractual obligations of the company; (c) identification of any cross-guarantees tied to different securities, and identification of major counterparties and a process for determining to whom the collateral of the company is pledged; and (d) any other information that the Board of Governors and the FDIC jointly require, rule or order.²⁰ Failure to submit an adequate living will may result in the divestiture of assets by command of the Board of Governors.

Title II of the Dodd-Frank Act provides Orderly Liquidation Authority (OLA) provisions. The Act authorises the FDIC to pursue an agency-administered wind-down for certain troubled financial firms.

The OLA provisions are a reaction to policymakers’ and legislators’ dissatisfaction with the two options that existed at the time of enactment of the Dodd-Frank Act and its OLA provisions. They could either: (i) allow the firm to enter bankruptcy; or (ii) if policymakers believed that bankruptcy was likely to produce a widespread systemic impact on the financial sector, the government could provide a bail-out – for example, to forestall failure. Pellerin and Walter (2012)²¹ identify some problem areas of bankruptcy as a means of handling failure when applied to large non-bank financial institutions. The authors argue that any resolution regime, whether bankruptcy, bail-out or OLA, must address two fundamental problems for institutions facing financial troubles.

The first problem is preserving “asset complementarities” and “going concern value” in the face of detrimental creditor incentives to rush to grab the assets of financial institutions upon

²⁰ 12 U.S. Code § 5365: Enhanced supervision and prudential standards for nonbank financial companies supervised by the Board of Governors and certain bank holding companies.

²¹ S. Pellerin and J. Walter (2012). Orderly Liquidation Authority as an Alternative to Bankruptcy, *FRB Richmond Economic Quarterly*, 98(1), 1–31.

a default. The second problem is determining whether to “liquidate” or “reorganise” the troubled firm. The bankruptcy may not be an optimal solution for some financial institutions, particularly SIFIs, because of its heavy dependence on short-term funding as well as “qualified financial contracts (QFC)”,²² which are likely to result in financial difficulties for the counterparties of failed financial institutions. The Dodd-Frank OLA provisions create alternative resolution arrangements for SIFI addressing the difficulty of bankruptcy with explicit goals of mitigating risk to the financial system and minimising moral hazard.

Pellerin and Walter (2012) observe that the OLA adjust the ways of handling QFC and paying out the creditors. If the FDIC, for example, wants to transfer all of the QFCs with a particular counterparty and its affiliates to a third party (including a bridge company), the counterparty has no right to terminate or close out the contract. Here, the QFC counterparty may find their contract with a new and more stable counterparty or a temporarily bridge bank so that the market is not disrupted by their original counterparty’s failure. However, a temporary adjustment to a QFC or paying creditors often increases the moral hazard problem. Therefore, the threat of a SIFI’s failure presents a daunting challenge for policymakers that neither bankruptcy nor the OLA provisions are capable of fully resolving.

In conclusion, jurisdictions around the world are working on various aspects of the recovery and resolution framework, including insolvency management, largely depending on the nature and scale of recent developments in their banking and financial market systems. The primary objective of the measures is to maintain financial stability and minimise losses for society, and, in particular, taxpayers, to ensure normal bankruptcy or insolvency proceedings in terms of allocation of losses to shareholders and creditors. The above discussion of the Key Attributes, proposals, guidelines and directives highlights a few key elements:

- relevant financial institutions and appropriate supervisory and resolution authorities should be adequately prepared for crisis management;
- the authorities should have adequate powers to intervene in the failing institutions; and
- a harmonisation between authorities is needed in order to take rapid action to implement tools and powers.

²² The class of financial contracts that are exempt from the automatic stay are commonly referred to as “qualified financial contracts”. Therefore, investors who are holding QFCs have the ability to immediately terminate and net-out their contracts or to liquidate the collateral on their claims once a party has defaulted or filed for bankruptcy.

2.2 Issues of Recovery and Resolution Programmes for Islamic Finance

From a global perspective, Islamic banks and financial institutions are relatively small. However, there are some Islamic banks or important conventional banks with Islamic “windows” and subsidiaries that are systemically important, at least at the national level. The complexities posed by the operation of Islamic banks, and by their differences from conventional banks due to Sharī’ah compliance, highlight the need to reconsider existing recovery and resolution plans to determine whether they are suitable options for the Islamic banking industry. Conceptually, the recovery and resolution options for Islamic banks should be developed taking into consideration some of the unique rights and liabilities of Islamic banking and Islamic finance transactions. The roles of the supervisory authority in relation to the recovery and resolution options for insolvent individual IIFS need to be compared with the conventional setting discussed in the above literature and guidelines, and clarified.

The main distinctions between Islamic finance and conventional finance relate to the nature, type and extent of risk exposures that justify a given reward. Under relevant Sharī’ah principles, a reward is not justified if the risk exposure is removed or insufficient. For example, conventional banking embodies, as a fundamental premise, deposit preservation through “deposit insurance” or “guaranteed deposits”. However, Islamic finance (including Islamic banking) does not allow for deposit preservation in many instances. For example, in a *muḍārabah* contract, which is the basis of many Islamic banking “deposit” arrangements, the return on investment funds is not, and cannot be, guaranteed according to Sharī’ah principles. In developing and implementing a legal recovery and resolution framework, Islamic finance needs to consider the governance rules of the *muḍārabah* contract and a range of other contracts. The governance rules should be predefined in a way that the Islamic banks are required to acknowledge the right of investment account holders to monitor the performance of their investments and associated risks, and put into place adequate means to ensure that these rights are observed and exercised.²³ In other words, the IIFS should maintain its fiduciary duty during resolution periods to uphold the interests of IAH, whether the investment is restricted or unrestricted under the relevant *muḍārabah* contract. The interests of IAH should be treated as equivalent to those of the IIFS’s own shareholders. The challenges include ensuring the adequacy and readiness of infrastructure and skill sets to enable efficient and effective oversight that is responsive to the Sharī’ah requirements of the recovery and resolution framework.

²³ Principle 2.1 of IFSB-2: *Guidance Principles on Corporate Governance for Institutions offering only Islamic Financial Services [Excluding Islamic Insurance (Takāful) Institutions and Islamic Mutual Funds]* (December 2006).

Awadzi et al. (2015)²⁴ discuss the design of legal frameworks for the resolution of Islamic banks and the applicability of the FSB's Key Attributes in the event of resolution. The paper highlights the need for a well-defined RRP for Islamic banks that is integrated into its complex institutional framework. In this regard, the legal framework for resolution of Islamic banks needs to address specific issues of Islamic finance that do not apply to conventional banks. The authors conclude that robust RRP prepared by the resolution authority would enable monitoring of Islamic banks from the point of view of financial stability and minimisation of losses in the event of a crisis. Moreover, the authors recommend that RRP for Islamic banks would need to be precleared by the relevant Sharī'ah boards, to promote smooth and swift resolution processes.

Tata (2012)²⁵ mentions that, since an effective insolvency and creditor rights regime is vital to stability in commercial relationships and financial systems that include Islamic finance, a number of issues need to be resolved in order to have an effective and workable interface between Islamic financial institutions and the global financial system.

Shukūk are a commonly used Sharī'ah-compliant financing instrument that differ from conventional bonds in terms of structure. (Securitisations are commonly used.) The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) provides standards pertaining to *shukūk*. The AAOIFI²⁶ states that *shukūk* are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular project or special investment activities. These standards distinguish *shukūk* from conventional equity, notes and bonds. McMillen (2008) argues the need for an effective legal framework that must address each of the diverse roles of the transactional participants in the structuring of these securities and their underlying transactions, as well as in managing portfolios, executing orders, and dealing in and distributing the securities. The issues raised by McMillen focus on the location of the originator, issuer and holders of *shukūk* in different jurisdictions, and on the fact that a single integrated *shukūk* transaction will frequently involve the laws both of purely secular jurisdictions and of Sharī'ah-compliant jurisdictions.²⁷ Yunis and Akhund (2008) argue that it is important to ensure the bankruptcy remoteness of the issuer of the special purpose vehicle (SPV) of the *shukūk*.²⁸

²⁴ E. A. Awadzi, C. Chartouni and M. Tamaz (2015). *Resolution Frameworks for Islamic Banks*, IMF Working Paper, WP/15/247, International Monetary Fund.

²⁵ V. Tata (2012). "Development of Effective Insolvency Regimes for Islamic Financial Institutions", *Effective Crisis Management and Resolution*, Fifth Islamic Financial Stability Forum, Manama, Bahrain, 29 December 2012, IFSB.

²⁶ AAOIFI Sharī'ah Standard No. 17: *Investment Shukūk*, 2015, p. 468.

²⁷ M. J. T. McMillen (2008). "Securities Laws, Enforceability and *Shukūk*", in *Islamic Finance: Global Legal Issues and Challenges* (Chapter 3, pp. 69–140). Kuala Lumpur: IFSB.

²⁸ H. Yunis and R. Akhund (2008). "An Analysis of Insolvency Laws as they Impact on Islamic Finance Transactions", in *Islamic Finance: Global Legal Issues and Challenges* (Chapter 2, pp. 49–67). Kuala Lumpur: IFSB.

Therefore, based on the above-mentioned discussion, this paper attempts to highlight the discussion from two perspectives:

- RRP frameworks do not encompass both conventional and Islamic banking; and
- RRP frameworks are available for conventional banking, but are not responsive to Islamic finance and issues related to Sharī'ah compliance.

A central bank or monetary authority may have responsibility for both monitoring recovery plans and implementing resolution frameworks for financial institutions, although recovery and resolution authorities are separated in some jurisdictions. Islamic banks and financial institutions function under a range of diverse scenarios. In some jurisdictions, there is a full-fledged Islamic banking system that is recognised as such and separately regulated. In other jurisdictions, Islamic banks are incorporated in and regulated by the regulators that have responsibility for the conventional banking system.

Few, if any, jurisdictions are likely to have a separate recovery and resolution authority for IIFS. In considering how to structure recovery and resolution for IIFS, attention must be focused on how the contracts and operations of IIFS differ from those of conventional banks and financial institutions. In jurisdictions where the contributions of both conventional and Islamic finance are significant, it would be necessary to consider whether it is feasible to enact separate legislation to deal specifically with recovery and insolvency for IIFS rather than to amend the existing legislation to address the specific needs of IIFS on an ad hoc basis. A lead resolution authority in a dual banking system will need to deal with both conventional and IIFS entities; ensuring that it has Sharī'ah expertise on hand (whether internal or external) is key.

Many threshold questions relating to recovery and resolution as they apply uniquely to IIFS have not yet been addressed. For example, financial institutions and recovery and resolution authorities need to determine the hierarchies in ranking shareholders and unsecured and uninsured creditors in order to liquidate or restructure in a feasible manner in regard to losses absorbed (FSB, 2011).²⁹ The FSB's Key Attributes framework recommends that the hierarchy measures adopted should explain the reasons for any departure from equal treatment (*pari passu*) in the payment of creditor claims.

Typically, shareholders' equity should absorb losses first, followed by subordinated debt holders (including all regulatory capital instruments) and unsecured creditors, in ascending order. On the bank's liabilities, depositors would be the last to absorb losses. As mentioned in

²⁹ Financial Stability Board (2011). *Key Attributes of Effective Resolution Regimes for Financial Institutions* (October).

the earlier discussion, Huertas (2013) clarifies that aggregated value of non-core Tier 1 capital, Tier II and senior debt should be at least equal to the required common equity Tier 1 for the purpose of any immediate bail-in so that it does not affect overall banking operations.

In contrast, some “deposits” by clients of an IIFS (including an Islamic bank) may not be “deposits” within the conception of interest-based banking and finance. Rather, they may be investment contracts. They are usually participatory arrangements between a bank and its customers as investors. The nature and extent of the difference of the treatment will depend upon the specific contractual agreements between each IIFS and its customers. For example, instruments based on a profit-sharing investment account (PSIA), in particular, that operate based on a *muḍārabah* or a *wakālah*³⁰ contract, do not and cannot provide, under Sharī’ah principles, any guarantee to the IAH either for the capital (principal) of a customer or for any return on such capital.

In many instances, the PSIA that forms the relationship between an Islamic bank and its customer can be further categorised into two types: (a) unrestricted PSIA (UPSIA); and (b) restricted PSIA (RPSIA). However, treatment of the funds, their guarantee and hierarchy, will depend on whether they are liabilities or equities. One implication of the profit-sharing and loss-bearing nature of PSIA (usually *muḍārabah* based) is their treatment from an accountancy perspective (whether on or off an IIFS’s balance sheet); this will differ from jurisdiction to jurisdiction. As an accounting matter, where the treatment is off-balance sheet, in the case of liquidation, account holders of PSIA funds have no claim as creditors over the assets of the IIFS (as do conventional depositors). Instead, IFSB standard IFSB-15 mentions that they have a claim to the assets financed by their funds (together with their share of any undistributed profits, less any losses), including their proportionate share of assets financed by commingled funds. In this regard, Najeeb and Mustafa (2016) explain Sharī’ah-compliant deposit insurance scheme measures for PSIA funds; however, they also raise questions on recognising the distinctive characteristics of PSIAs, and how to reflect the interests of IAH during liquidation. This paper will attempt to address the issues of guarantee and hierarchy for these particular types of Sharī’ah-compliant contracts for IIFS.

It is to be noted, however, that the accounting characterisation is not controlling or dispositive. It is one factor, among many, that will be considered by a court in a bankruptcy or insolvency

³⁰ In fact, the *wakālah* model, strictly speaking, is not a true PSIA since it is built on the earning of specific fees by the *wakil* (agent) regardless of profit or loss from the underlying activity, and the entire profit will be attributed to the *wakil* (capital provider). However, some jurisdictions consider it as PSIA, which is contradictory to the essence of *wakālah* from the Sharī’ah perspective. However, the reason for considering it as PSIA is due to the fact that the *wakil* might receive part of the profit as a performance-related incentive if the realised profit exceeds a certain level. In such cases, the *wakil* will share part of the profit with the investors, which is in reality considered a *hibah* or a commitment to pay it (IFSB Technical Note 2, December 2016).

scenario or by a regulatory authority in the resolution context. These courts and authorities will examine, in a form-over-substance process, the PSIA (and every other arrangement) from an economic perspective and characterise the arrangement based upon its economic substance, rather than any accounting, contractual or other characterisation.

CHAPTER 3: PRACTICAL APPLICATION OF RECOVERY, RESOLUTION AND INSOLVENCY FRAMEWORKS/TOOLS TO THE ISLAMIC FINANCIAL SERVICES INDUSTRY

3.1 Sharī'ah View on Recovery and Insolvency

The previous chapter outlined the current regulatory and conceptual understanding of recovery and resolution programmes and some bankruptcy/insolvency considerations. It also examined some key legal jurisdictions and their normative insolvency procedures. The overarching issue for the IFSI, from a structural, procedural and juridical perspective, is the requirements of Sharī'ah. The FSB's Key Attributes framework has been written for the conventional banking industry and takes no cognisance of Sharī'ah considerations. The recovery of capital and liquidity positions, the resolution framework and tools that a recovery and resolution authority should consider with respect to IIFS, and other complexities of an IIFS operating in an interest-based secular system, are also unconsidered by the FSB and other conventional organisations and authorities. Similarly, no national legal system exists that incorporates Sharī'ah principles pertaining to *iflās*³¹ (even in Muslim-majority countries that may derive some of their national law from Sharī'ah as a primary source).

An oft-quoted Qur'anic verse that addresses the matter of insolvency is: "*And if the debtor is in straightened circumstances, then (let there be) postponement to (the time of) ease; and that ye remit the debt as almsgiving would be better for you if ye did but know*" (Quran 2:280). From a *maqāṣid al-Sharī'ah* perspective, and in the modern corporate context, the favoured approach would be to allow reorganisation and restructuring (perhaps weighted towards extending the term of the debt), given that, generally, debt forgiveness (write-offs, whether partial or whole) is considered morally superior to an insolvency or liquidation proceeding. The obligation to pay off debt is, however, not only a legal obligation within Sharī'ah, but also a moral one; hence, the above represents a balanced and pragmatic approach for all parties.

AAOIFI's standard on procrastinating debtors³² states explicitly that a default by a debtor who is able to pay his or her debts is forbidden under Sharī'ah. This highlights the fundamental importance of repaying debts, of not delaying such payments unduly, and of not attempting to strategically avoid repayment when an individual (or corporation or other entity, as discussed below) is capable of paying.

Considering the above, Sharī'ah would emphasise the "recovery" aspect of recovery and resolution. Ideally, an IIFS should be recovered, reorganised and/or restored and salvaged,

³¹ *Iflās* is when the debt due of a person exceeds his or her assets (insolvency).

³² AAOIFI Sharī'ah Standard No. 3: *Procrastinating Debtor (Revised Standard)*, 2015, pp. 88–90.

with the resolution and insolvency process being the final resort. In the bankruptcy process, Sharī'ah principles with regards to asset sales, creditor hierarchies and procedure need to be examined in the context of the contemporary use of Islamic finance structures and contracts, as well as against the backdrop of operating in financial systems that are structured and operate on interest-based principles. This chapter will examine the key issues for the banking, finance, capital market and *takāful* sectors with regards to recovery, restructuring, and bankruptcy and insolvency. It will also consider how the IFSI market can strategically ensure that Sharī'ah principles are entertained during bankruptcy and insolvency proceedings in legal frameworks that are mute on the point of Sharī'ah compliance.

3.2 Why Does the IFSI Need Effective Recovery, Resolution and Insolvency Regimes?

As mentioned previously, the key issue being addressed by this paper is the need to harmonise Sharī'ah principles of RRP and bankruptcy and insolvency frameworks that are currently embodied in secular legal systems, and to offer guidance and solutions on this area to relevant authorities. Why is this needed? The answer is twofold: (a) financial stability; and (b) Sharī'ah compliance.

3.2.1 Financial Stability

As highlighted in the Bank of England's (BoE's) consultation paper on the Bank Resolution and Recovery Directive (CP13/14), the GFC illuminated various shortcomings and gaps in recovery and resolution tools available to RSAs. Government intervention through the use of public funds helped to bail banks out of the crisis. The general panic and market sentiment caused a wide degree of contagion, which not only put the financial system in jeopardy, but has had major ongoing ramifications for national economies.

An efficient recovery and resolution regime, as well as a robust bankruptcy and/or insolvency procedure, is a key safety net for the financial system. This is particularly important when institutions become so large and so deeply embedded in the wider economy (through both their operations and their performance of critical economic functions) that their failure can lead to major economic damage. Similarly, the use of public funds to prevent large banks and financial institutions from failing leads to moral hazard. Banks and financial institutions may become lax with regards to their risk management, or be incentivised to take more risk and to maximise profits if they feel that any loss events and insolvency repercussions will be absorbed ultimately by the government (which, in turn, derives the funds from the taxpayer).

The popular term “too big to fail” is a status quo that RRP particularly seeks to address and mitigate.

The same issues of financial stability arise throughout the IFSI. Jurisdictions that have a developed Islamic market, to some greater or lesser extent, will be subject to systemic risk³³ should a large and critical institution fail. Similarly, IIFS are not beyond moral hazard and may also be reliant on government bail-outs should an insolvency or liquidity crisis occur. An efficient and functional RRP (and bankruptcy and insolvency) regime is needed for the IFSI for much the same reasons it is required in the conventional, interest-based industry. Added to this, the IFSI has complexities from a structural and legal perspective that warrant further examination. An RRP regime must be sensitive to the contracts, practices and risk allocations of IFS, and develop tools to address these contracts, practices and risk allocations in order to effectively administer recovery and resolution of a potential or actual IIFS failure. Only then will the aims of achieving financial stability and reducing moral hazard be satisfied.

3.2.2 *Sharī'ah Compliance*

As emphasised, the key underpinning of the IFSI is the Sharī'ah principles that animate the relevant transaction and structure and provide specific remedies based on the rights and responsibilities of each party. Some of these rights and responsibilities may only be realised when a default event occurs. The following cases illustrate how some of these principles may become lost or be ignored when heard in a secular legal context that does not take cognisance of the Sharī'ah, and how this may fundamentally change the relative and absolute positions of the contracting parties from what the Sharī'ah contract may stipulate and from what the parties may have agreed.

One of the earliest cases to be heard and reported in the UK judicial system pertaining to Islamic finance was that of *Symphony Gems N.V. and Ors*.³⁴ The case concerned a *murābaḥah* arrangement whereby the plaintiff agreed to finance the defendant with a revolving credit facility for the purchase of precious gems and stones. The defendant (the purchaser) defaulted on its repayment obligation under the *murābaḥah* contract. One of the issues discussed by the court was the determination of the effect of the *murābaḥah* arrangement on the risk of failure to deliver the goods. From a Sharī'ah perspective, most of the risks pertaining to failure to deliver the asset(s) rest with the seller. In many instances, non-delivery can lead to legitimate withdrawal and non-performance of the contract by the purchaser. This Sharī'ah

³³ As per the IFSB's *IFSI Stability Report 2017*, there are currently 12 jurisdictions globally where Islamic finance bank assets are >15%, the threshold for systemic importance.

³⁴ *Investment Company of the Gulf (Bahamas) Limited v Symphony Gems N.V. and Ors* [2002] West Law 346969, QBD (Common Court).

principle was rejected by the UK court in the context of this case. The UK court examined the contract and enforced a clause that stated the seller would not be liable for any failure to deliver or for defects with regards to the goods. This, it can be argued, contravenes the Sharī'ah principles underpinning a *murābaḥah* arrangement.

The case highlights two key issues with regards to Islamic finance insolvency and Sharī'ah compliance: (a) the possible failure to consider the underlying Sharī'ah principles and the contractual intent of parties, as embodied in the contract; and (b) secular legal systems taking cognisance of the Sharī'ah. It is arguable that, in the *Symphony Gems* case, the contract may not have been interpreted in accordance with applicable *murābaḥah* principles and the allocations of risks and responsibilities that would be borne by both parties from a strictly Sharī'ah perspective. As is customary under international secular law principles, the UK court would not entertain introduction of Sharī'ah compliance arguments on the grounds that the Sharī'ah is not a national law (as it must be under international treaties) that can be recognised as the governing law of a contract.

Sharī'ah compliance during the bankruptcy or insolvency proceeding becomes critical in upholding overall Sharī'ah principles and differentiating Islamic finance transactions from other forms of finance. Similarly, Sharī'ah-compliant recovery and resolution methods and tools are also critical for ensuring that a holistic IFSI exists, in much the same way that there is a demand and desire for Sharī'ah-compliant deposit insurance schemes.

3.3 Sharī'ah Principles in Insolvency and Bankruptcy

It is important first to understand what the terms “insolvency” and “bankruptcy” mean, and then to understand the Islamic construct of such procedures. Insolvency may be either of two things: (a) a debtor's inability to pay his or her creditors; or (b) an excess of liabilities over assets. Bankruptcy is a legal declaration of one's inability to pay off debts owed. The legal proceeding that follows may be intended either to reorganise/restructure the failed entity, or to liquidate the assets for the benefit of the creditors. Insolvency can be described as a state of being which may then result in the bankruptcy proceeding.

A public declaration of insolvency, moving it from a privately known condition to a public one, is of significance within the Sharī'ah. As can be seen in the Sunnah of the Prophet Muhammad (ﷺ), where he forbade the example of a sale whereby an individual meets a seller outside of the city and purchases his or her goods at a price lower than the prevailing market rate in the city. True price discovery is not possible in this example and puts the seller at a disadvantage; it also prevents other market participants from being able to bid fairly for the same goods in an open exchange medium (much like the debate over “lit” exchanges and dark pools).

The lack of public declaration of an insolvency event can cause counterparties to behave differently and to have differing expectations. If only a small number of creditors are aware of the insolvent condition, they may seek an advantage derivable from this information asymmetry and secure their own interests before others. From such Sharī'ah principles, we begin to see the importance that is placed on the public declaration of insolvency (including by way of the initiation of a bankruptcy proceeding).

3.3.1 *Iflās*

The Arabic term for bankruptcy is *iflās*.³⁵ Similar to the conventional understanding of bankruptcy, *iflās* can be due to assets being less than liabilities, as well as to the inability to meet liabilities as they fall due (the state of insolvency). In Sharī'ah, there is no differentiation between the individual and the corporation. The modern corporate notion of limited liability structures that create delineated legal personalities (individual versus business) is not considered in *iflās*. In classical Islamic jurisprudence, the closest thing to a legal entity that developed is the *waqf* (endowment) structure.³⁶ The liabilities of a business enterprise were therefore also the liabilities of the individual owners/partners of the business. Contemporary legal frameworks for some, but not all, legal entities do differentiate between owners/partners in a business and the business entity with regards to liabilities/debts. Islamic contracts are, in the modern context, overlays against this framework. The modern notion of a corporate entity is not prohibited in any way under Sharī'ah. It may be applicable, therefore, to transpose the rules of individual *iflās* to the corporate personality. Similarly, the Islamic partnership contracts of *mushārah* and *muḍārah* do not allow loss to exceed the amount of the initial capital invested, which is itself a limitation of liability. If creditors of a limited liability company or corporation or a *mushārah* or *muḍārah* do not recoup the total amount of the obligations due to them from the failed entity, there is no general obligation to the shareholders to fill the gap. In this regard, we see that Sharī'ah would not place individual burdens on the owners of a failed business – unless, perhaps, the failure is due to fraud/negligence.

The AAOIFI has issued a standard³⁷ with regards to IIFS insolvency. Procedural requirements are detailed from a Sharī'ah perspective. The stages of insolvency specify that creditors should seek the assistance of a concerned authority when their demands for debt payment are not satisfied by the debtor through the filing of a claim. The standard also states that the debtor can make an application for an insolvency declaration to the relevant authority, which

³⁵ H. Wehr (1994). *Dictionary of Modern Arabic* 850 (J. M. Cowan, ed.).

³⁶ A. Awad and R. E. Michael (2010). *Iflās* and Chapter 11: Classical Islamic Law and Modern Bankruptcy, *The International Lawyer*, 44, 975.

³⁷ AAOIFI Sharī'ah Standard No. 43: *Insolvency* (May 2010).

is not permitted under classical formulations of *iflās* principles. The authority (likely a judge/court) will then assess the claim and make the declaration of insolvency. It is clear from the standard and from generally accepted Sharī'ah principles that insolvency is a condition that requires assessment and declaration by a competent authority.

The AAOIFI standard also states that, under Sharī'ah, there is a moral obligation on the debtor not to carry out any action that may further harm his or her creditors. Also, should the creditors demand, the court or judge may physically sequester the debtor's assets. Legal sequestration is secondary to moral obligation in upholding and protecting the interests of the creditors by the insolvent party. This is a reiteration of the importance placed on the repayment of debts within Sharī'ah.³⁸ Debt cannot be extinguished except by repayment in full or by its voluntary forgiveness by the creditors. The taking on of debt, therefore, carries with it a very stringent moral responsibility. This needs to be considered closely in the context of what we understand by modern insolvency and bankruptcy procedures and non-Islamic legal frameworks.

Importantly, the AAOIFI standard also states that creditors of an insolvent institution are not required to prove that they are sole creditors; they do not bear the moral or legal burden to inform the authority or court of the interests of other creditors (which are likely to be competing interests). Any creditors that appear after the distribution are entitled to a pro-rata share of the remaining amount(s). This emphasises the importance of a public declaration of insolvency by the requisite authority. It allows all creditors to know the true position of the debtor and to make timely claims in an attempt to recover their funds. Any obfuscation or information asymmetry in this respect is therefore detrimental.

Procedurally, the AAOIFI standard states that the sale and distribution of the debtor's assets should not be done with excessive haste (i.e. fire sales, etc.), which may hurt the debtor's position (and, indeed, that of the creditors). Developed recovery and resolution frameworks are also cognisant of minimising price dislocation as a result of recovery/resolution. Of course, this needs to be contextualised in terms of market sentiment. A market that becomes aware of a bank/financial institution in stress is likely to attempt to purchase (if it decides to purchase at all) assets at a discount to their face value. The severity of the stress, or indeed the desperation of the sale, can further impact on this discount.

³⁸ Narrated by Salamah bin al-Akwa': "Once, while we were sitting in the company of the Prophet, a dead man was brought. The Prophet was requested to lead the funeral prayer for the deceased. He said, 'Is he in debt?' The people replied in the negative. He said, 'Has he left any wealth?' They said, 'No.' So, he led his funeral prayer. Another dead man was brought and the people said, 'O Allah's Apostle! Lead his funeral prayer.' The Prophet said, 'Is he in debt?' They said, 'Yes.' He said, 'Has he left any wealth?' They said, 'Three Dinars.' So, he led the prayer. Then a third dead man was brought and the people said (to the Prophet), 'Please lead his funeral prayer.' He said, 'Has he left any wealth?' They said, 'No.' He asked, 'Is he in debt?' They said, 'Yes! He has to pay) three Dinars.' He (refused to pray and) said, 'Then pray for your (dead) companion.' Abu Qatada said, 'O Allah's Apostle! Lead his funeral prayer, and I will pay his debt.' So, he led the prayer." (Bukhārī, Book 37, Ḥadīth 488).

With regards to creditor hierarchies, the AAOIFI standard states that the following order should be followed with regards to distribution:

- (a) secured creditors (as per the rules of granting security);
- (b) fees owed to non-employee contractors and lessors (who can establish a lien over any of the debtor's property in their possession in this regard);
- (c) anyone who finds an item of property that is specifically theirs will have a preferred claim over it;
- (d) the rest to be distributed to creditors, each receiving a pro-rata share of the aggregate due to all creditors (as distribution does not need to wait for all assets to be sold); and
- (e) any ex post debt discovery should be claimed by the new creditor from the other creditors who have already received distribution.

The AAOIFI standard also states that current accounts held with the IIFS are liabilities of the IIFS, which must be borne by it alone and which should not be borne by the investment account holders. As for investment vehicles that are independent of an IIFS in their fund sources and revenues, they shall not be part of the insolvency assets. Such investment vehicles include restricted deposits, funds and portfolios that are not wholly or partially owned by the IIFS in which the IIFS's responsibility is limited to managing on a paid agency or *muḍārabah* basis.

Many insolvency regimes have differences in terms of creditor hierarchies and pay-outs upon liquidation. Amounts owed to the government (e.g. tax) and other statutory items will be paid first. Secured creditors would likely be second, and then unsecured creditors (on a pro-rata basis). A challenge for the IFSI in this context is to harmonise prevailing creditor hierarchies as per the local legal framework with that of Sharī'ah. The treatment of PSIA's in both a restructuring/recovery and liquidation scenario can be a particularly complex issue, depending on the legal status they hold. A predefined governance framework is needed between IIFS and IAH which will define IAH's right to monitor the performance of their investment and associated risks. Although the IAH would usually rank *pari passu* with the shareholders in any IIFS's assets, IIFS as a party on the *muḍārib* side of the *muḍārabah* contract also owe a fiduciary duty to the IAH and need to ensure protection of IAH's interests.³⁹

It should also be noted that despite the severity of Sharī'ah with regards to indebtedness and the rights of creditors, principles of fairness and justice in the insolvency process are still key.

³⁹ IFSB-2: *Guidance Principles on Corporate Governance for Institutions offering only Islamic Financial Services [Excluding Islamic Insurance (Takāful) Institutions and Islamic Mutual Funds]* (December 2006).

Creditors may not (in most circumstances) threaten or exploit the indebted party.⁴⁰ Specifically, there may be no increase in the amount of debt owed due to extended repayment schedules (which can be seen as embedded *ribā*). The creditors are expected to ease the debtor's circumstance by giving more time for repayment (indicating a preference for restructuring) and debt forgiveness. Arriving at a balance between all these principles given contemporary IIFS transactions and structures is a key challenge for establishing an effective insolvency regime in the IFSI.

Given the general rules and themes of *iflās* discussed here, the importance of debt repayment and the rights of the creditors are emphasised. However, it is also deemed morally favourable to give time/relief so that a distressed entity can restructure/reorganise itself. As this paper has previously mentioned, there is a distinction between insolvency and bankruptcy. Insolvency is a state, which can lead to the legal proceedings of bankruptcy. Bankruptcy itself may involve liquidation or reorganisation/restructuring. The rules of *iflās*, it can be argued, are more closely aligned to latter.

3.4 Key Recovery Issues in the IFSI

Having established the overarching principles of Islamic insolvency/bankruptcy, this chapter will examine the issues around recovery and resolution across the three main IFSI sectors: banking, capital markets and *takāful*. The chapter will discuss these issues in the light of global requirements (namely, the FSB's Key Attributes) and regulatory best practices, as well as other literature on the subject.

3.4.1 Banking

Islamic banking is by far the largest component of the IFSI. Yet, Islamic banks have been largely absent from the ongoing discussions globally around recovery and resolution and the safety of financial systems. This is not surprising given that the industry is still relatively small in comparison to its conventional counterpart.⁴¹ No Islamic banks have yet achieved G-SIB status, although a few are now at the Domestic Systemically Important Bank (D-SIB) stage.

Discussions of recovery and resolution are hinged on systemic importance, with those entities deemed to be a significant risk to financial stability should they fail being given preferential focus by regulators. The specificities and structural and legal issues that surround the recovery

⁴⁰ Consider, however, *mulāzamah* ("close attachment" or "clinging to" debtors), which is discussed in F. J. Ziadeh (2000). *Mulāzamah* or Harassment of Recalcitrant Debtors in Islamic Law, *Islamic Law and Society* 7, 289.

⁴¹ H. Abdelhady (2013). Specialized Insolvency Regimes for Islamic Banks: Regulatory Prerogative and Process Design, *World Bank Legal Review*, 5, 127–46.

and wind-down of an Islamic bank have therefore not yet drawn specific policy arrangements. There may also be a lack of general recovery and resolution planning, even in key jurisdictions where Islamic banking is more developed. In this instance, the discussions in this paper can be taken by RSAs to help lead their thinking when they do develop such regimes for their IFSI.

This section of the chapter will examine some key issues for Islamic banks in the recovery, resolution, and bankruptcy and insolvency area. These are:

- the use of recovery tools: liquidity/capital recovery;
- the use of resolution tools: bail-ins, asset transfers and bridge banks;
- the treatment of investment account holders; and
- the treatment of profit equalisation reserve and investment risk reserve funds.

The examination will draw on current literature and research in the area, and on examples from jurisdictions across the globe.

3.4.1.1 Recovery Tools

The FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions* (October 2011) framework recommends that RSAs ensure that firms within their jurisdiction create and maintain a recovery and resolution plan. These RRP should include "*scenarios that address capital shortfalls and liquidity pressures*". The Prudential Regulatory Authority's (Bank of England) supervisory statement on recovery planning⁴² goes into detail on what the regulator expects an RRP to contain from the recovery element. Module 2 of Table A in the document details the recovery options section and asks for details around what the recovery option is, its credibility and specific quantifications (both around the option and its impact on overall liquidity/capital).

Recovery options, as the term suggests, are actions undertaken by a financial institution (this section focuses on the banking context) during a stress event that may help the institution to recover its capital or liquidity position. This may involve the sale of assets, utilisation of pre-agreed credit lines, intragroup support, central bank facilities, and (where possible) the prevention of withdrawal outflows.⁴³ The firm itself must first assess and identify viable options as part of its RRP. It must also quantify the impact of such options given that they will be conducted in a stressed environment. This may result in asset sales with significant haircuts,

⁴² SS18/13, Recovery Planning – Bank of England (PRA), December 2013 (updated January 2015).

⁴³ Many of these recovery concepts are incorporated into bankruptcy proceedings in jurisdictions that adopt a bankruptcy concept (as opposed to a liquidation one). Bankruptcy is the process (i.e. administration) by which an insolvency is resolved.

for example. The RSA will conduct its own assessment of a firm's recovery options as detailed in its RRP, providing challenges found in its review.

Recovery options may incorporate in-depth historical data analysis to better understand how distressed sales, and other actions, are likely to perform in a stressed market. Ideally, they will reflect the outputs of a firm's stress-testing scenarios. It is not absolutely certain, however, how these recovery options will perform in reality, given that historical analysis has its own limitations. Importantly, these recovery options can be taken by a firm to prevent failure. They act as an action plan with a pre-identified strategy that can be executed during a stress event. The firm (and the RSA) will also have an idea as to what the impact of such actions would be.

Recovery is the key element of the RRP. It is an attempt to prevent failure and to avoid a resolution, liquidation or insolvency event. For Islamic banks and financial institutions, each of the common recovery options that have been mentioned above needs to be examined to see if there are any structural and/or Sharī'ah issues that may be an obstacle to their usage and something of which the IFSI needs to be aware.

3.4.1.1.1 Central Bank Facilities

A common liquidity recovery option for a bank would be to access central bank facilities, such as emergency liquidity and reserve accounts. A prerequisite to this in most central banking frameworks would be that a bank is a member of the market or monetary framework. In the UK, for example, facilities such as those mentioned, as well as the discount lending window, require membership to the sterling monetary framework of the BoE. In turn, commercial banks must place conventional collateral (bonds) with the BoE in order to be part of this framework, which effectively bars Islamic banks in the UK from joining. Therefore, this often-used recovery option is not available to Islamic banks. (At present, the BoE is in the process of structuring Sharī'ah-compliant LOLR facilities⁴⁴ and reserve account facilities.⁴⁵)

The IFSB's working paper (WP-01) on SLOLR facilities⁴⁶ found that only six RSAs had developed such a facility as of its date of publication, although there was sentiment echoing its importance for the IFSI market in the local jurisdictions. Some of the reasons as to why such facilities had not yet been developed included legal and regulatory impediments (changes to the legislative framework/the acceptance of Sharī'ah-compliant collateral by

⁴⁴ Bank of England (2016). Consultation Paper: *Establishing Sharī'ah-compliant Central Bank Liquidity Facilities* (February).

⁴⁵ Bank of England (2017). Consultation Paper: *Sharī'ah-compliant Liquidity Facilities: Establishing a Fund-based Deposit Facility* (April).

⁴⁶ IFSB Working Paper Series, WP-01/04/2014: *Strengthening the Financial Safety Net: The Role of Sharī'ah-compliant Lender-of-last-resort (SLOLR) Facilities as an Emergency Financing Mechanism*.

central banks) and policy focus (where the IFSI is small and/or underdeveloped). This paper notes that the SLOLR is not the only facility that a central bank can supply to a bank in stress. The reserve account is also an important liquidity draw-down facility and one that will not attract a haircut or (in theory) market turbulence in terms of access. Other liquidity injections such as discount lending are also tools that a bank can use to help recover liquidity before it has to turn to the central bank as a last-resort lender. Of course, Islamic banks would not be able to avail themselves of interest-based loans from a central bank.

For a number of jurisdictions, Islamic banks may not be able to include central bank options as part of their RRP due to the lack of available Sharī'ah-compliant facilities. The IFSB's working paper does outline some potential structures for SLOLR that could also be used generally by a central bank to provide emergency liquidity support to a failing Islamic bank. Notably, these are the *qarḍ al-ḥasan* (*qarḍ*) (interest-free loan) and *muḍārabah* models. Both require collateral to be pledged by the bank to the central bank.

The *qarḍ* may allow for an administrative fee to be charged; however, it must be a non-interest bearing (and non-profit-bearing) loan. The usual practice of LOLR facilities is that they charge a high lending rate given the level of risk being taken by the central bank in lending money to a failing entity. The *muḍārabah* option allows for a profit rate to be charged by the central bank. The facility being provided is more akin to an equity investment in the failing bank, where the funds may be mixed with other IAH money. Such options may present a level of risk that many central banks are unwilling to take (especially the *muḍārabah* model).⁴⁷

Wider policy thinking around the development of Sharī'ah-compliant central bank facilities and access for Islamic banks to the open market operations of their central banks is generally required in a number of jurisdictions where IFSI participants are present. This is an important liquidity recovery option found in the recovery strategy for many conventional banks in their RRP. While a conventional LOLR facility may well be used by even an Islamic bank under the doctrine of necessity (*ḍarūrah*) to prevent absolute failure, general Sharī'ah-compliant liquidity injections during stress periods simply do not exist in many jurisdictions. This is something for RSAs to consider when formulating policy and promulgating regulations around the recovery module for Islamic bank RRP. The danger is that such a recovery tool may well be "off the table" otherwise.

⁴⁷ Other mechanisms to provide SLOLR that have been discussed in the working paper have used the following underlying Sharī'ah-compliant structures: *mushārah*, *murābahah*, commodity *murābahah*, *tawarruq*, *qarḍ* with *rahn*, etc. Short-term *ṣukūk ijārah*, Islamic Treasury bills or the equivalent, Islamic government investment certificates and Islamic certificates of deposit (CDs). Please see: IFSB Working Paper Series, WP-01/04/2014: *Strengthening the Financial Safety Net: The Role of Sharī'ah-compliant Lender-of-last-resort (SLOLR) Facilities as an Emergency Financing Mechanism*.

3.4.1.1.2 Asset Sales

A common recovery option that may be found in the RRP of banks that have a developed recovery and resolution framework is the selling of assets both to improve the risk-weighted asset (RWA) and capital position and to realise a liquidity inflow. Such distressed sales are done with the understanding and acceptance that haircuts will need to be taken against the face value of such assets. The recovery part of the RRP module, as can be seen in the BoE template, contains sections that ask banks to detail how much anticipated haircut there will be. Such quantifications can be made through historical data analysis. The role of the RSA will be to assess whether the quantifications are realistic and whether such a value can be realised during a stressed market scenario. There are two key issues with regards to asset sales that may arise in the Islamic model: (a) the Sharī'ah acceptability of sales at less than face value; and (b) determinations of who may purchase such assets.

As shown in the IFSB's prudential and structural financial indicators project,⁴⁸ a vast majority of global Islamic banking assets are made up of the following contracts: *murābaḥah*, commodity *murābaḥah*, and *al-bay' bi al-thaman al-ājil* (c. 66.1%). These contracts are debt contracts in nature. Prominent international *fatwa*-issuing bodies – namely, the AAOIFI and the Organisation of Islamic Cooperation (OIC) Fiqh Academy – have held that debt cannot be sold to anyone other than the debtor.⁴⁹ It is also generally accepted by classical Sharī'ah jurists that the sale of the debt to the debtor himself was permitted.⁵⁰ Where jurists have held that debt sales to a third party can be permissible,⁵¹ the majority opinion is that this must be at par value; debt assets such as *murābaḥah* cannot generally be sold at a discount or a premium due to issues around embedded interest.

Following this reasoning, we are left with the implausible scenario whereby an Islamic bank trying to recover its capital position through distressed asset sales would need to ensure that the debts are sold at full face value. In this context, it is worth noting that the vast majority of the assets of an Islamic bank are in the nature of debt. General market behaviour and psychology would render this impossible. The danger here, from a recovery perspective, is that asset sales are one of the go-to options for a bank in stress. As the general make-up of Islamic bank assets is debt in nature (financing contracts), and debt cannot be sold at less

⁴⁸ www.ifsb.org/psifi_02.php

⁴⁹ ISRA Research Paper No. 40/2012: *Fatwas on Islamic Capital Markets: A Comparative Study Between Malaysia and Gulf Co-operation Council (GCC) Countries*.

⁵⁰ The majority of jurists permitted the sale of confirmed debt to the debtor. Thus, the creditor can sell the debtor the confirmed debt, which is established on the debtor's liability for another counter value of different genus. Therefore, the sold confirmed debt is settled and its compensation must be paid by the debtor.

⁵¹ The Malaysian Securities Commission Sharī'ah Advisory Council resolved in 1996 that debt could be sold to a third party (*bay' al-dayn*).

than its face value, RSAs will need to consider the impact this has on a bank's ability to recover its capital position.

A new structure that is being used is that of debt–commodity exchange.⁵² Effectively, a bank may exchange debt assets for a certain commodity that has been bought in the market by the purchaser. The commodity can then be sold by the seller for cash. Arrangements for such a transaction may result in cash being received (ultimately) through the commodity sale, which may be at less value than the face value of the debt that was exchanged. This structure has not been accepted and approved by all Sharī'ah scholars. In the opinion of some Sharī'ah scholars, this transaction is akin to an organised *tawarruq*, whereby the exact price of the commodity is known and the transaction occurs in such a process whereby the seller of debt knows exactly how much cash they will receive from the commodity sale. (Effectively, this is the price for which the counterparties would have agreed to purchase the debt assets.)

The OIC Fiqh Academy has ruled the organised *tawarruq* as being impermissible under Sharī'ah, and there is some uncertainty as to what structures constitute organised *tawarruq* in this context.⁵³ The above may also fall under such impermissibility for a number of *madhāhib*. Exchanging debt for commodities is itself not prohibited. In a stress scenario, a bank may exchange its debt assets for a commodity. If this transaction is not pre-planned, and there are only estimates as to how much cash the seller may realise as a result of selling the received commodity in the open market (which may also be subject to distressed haircut conditions), such a recovery option may be more viable generally under Sharī'ah. There are, of course, operational issues in carrying out such a transaction, and whether it can be practically carried out in a severe stress scenario is questionable.

There may be a need for Sharī'ah boards (whether centralised or at the bank level) to consider whether a dispensation can be given to Islamic banks and financial institutions in such a situation that allows them to sell their debt assets at a lower value in order to try and recover the entity and avoid a resolution event. Such conversations and decisions should take place early, so that when a jurisdiction begins developing its RRP framework, there is greater clarity in terms of the precise recovery options that may be available to an Islamic bank.

An added complexity with this recovery option may relate to the identifiable purchasers of an IIFS's assets/business units. In a vast majority of jurisdictions (with Sudan and Iran being the notable exceptions), the IFSI exists alongside conventional financial institutions. As per the IFSB's Implementation Survey (2017), of all such jurisdictions, Islamic banks constitute a

⁵² A. M. Ab Mumin (2012). Bay' al-Dayn bi al-Sila' – A Breath of Fresh Air for the Islamic Capital Market, *New Horizon – Global Perspectives on Banking & Insurance*, 183 (April–June).

⁵³ OIC Fiqh Academy Resolution No. 179 (19/5).

majority by share of total bank assets in only two.⁵⁴ If Islamic assets can be sold, the question remains as to whether only other Islamic banks are allowed to purchase them. According to the IFSB's Prudential and Structural Islamic Financial Indicators (PSIFIs) data, Islamic bank assets across a range of jurisdictions are heavily concentrated in three economic sectors: (i) real estate financing; (ii) vehicle financing activities (i.e. *ijārah*); and (iii) other household financing. It is feasible, therefore, that a market-wide stress event may well impact all Islamic banks in a particular jurisdiction with the same degree of severity. If this is the case, all Islamic banks may be trying to sell their assets at the same time in order to recover their capital positions. The question must be asked: Who will then be a purchaser, for this option to be viable?

Given that the legal nature of Islamic banking and the Sharī'ah principles that underlie it are different from conventional finance, RSAs will need to consider whether an Islamic bank can sell its assets to a conventional bank in a stress event if no other buyers are available. This, of course, raises a number of operational questions; for example, how would a conventional bank continue to ensure Sharī'ah compliance? Legal documentation and novation of contracts is also a potential issue (which will be discussed in more detail later). RSAs need to consider such risk concentration issues when developing a recovery and resolution framework for their Islamic banks.

Opening up recovery sales to conventional entities does, however, raise a number of issues. Some jurisdictions may, for example, have legal impediments, or require specific regulatory approval for such a sale to take place. A pre-approval mechanism with caveats/trigger points could be an example of how such a sale could be effectuated quickly in a stress event if needed. Such considerations will be specific on a country-by-country basis. However, if, as described, there are issues with asset sales within the Islamic banking population alone, a recovery and resolution framework for IIFS needs to remain cognisant of such matters.

One of the key matters raised by such a sale is that of preserving Sharī'ah requirements and compliance. The buyer may have to restructure, revise or terminate contracts at various stages and will be doing so without any prior Sharī'ah operational/legal experience. The absence of any Sharī'ah committees, boards or infrastructure can, therefore, jeopardise the Sharī'ah compliance of the assets/business units. As has been discussed in this paper previously, maintaining the Sharī'ah animation of IIFS contracts and assets while going through a recovery/resolution scenario should be a primary focus of any such framework. In such a situation, it may be prudent to have mechanisms in place that identify Sharī'ah boards/advisers that non-IIFS can access easily (whether within the failing IIFS group or external). Similarly,

⁵⁴ Brunei (56%) and Saudi Arabia (51%). Malaysia has a sizeable share at 28% and Kuwait at 39%.

the framework would need to give consideration as to whether product-level requirements (whether Sharī'ah or operational) that apply to IIFS assets would continue to be applicable to the conventional buyer. This is particularly poignant for Pillar III disclosure regimes, where separate reporting may be required for IIFS in certain jurisdictions (on prudential metrics), and specific disclosures are required around PSiAs and Sharī'ah governance.

From a recovery perspective, RSAs may want to consider thinking more broadly than just the banking sector with regards to asset buyers in stress scenarios. PSiAs share many of the features of the asset management/collective investment scheme model. It may be feasible, therefore, for asset management entities to purchase and continue operating such accounts should an Islamic bank need to sell this line of business in order to recover its capital position. (Where a jurisdiction is using an *alpha* weighting for capital calculations, this needs to be factored into the impact such a sale would have on the overall RWAs and regulatory capital.) There are considerations that need to be made regarding how a non-Islamic entity would run such accounts – for example, what investments it can make, Sharī'ah screening, etc. Given that there could be a lack of buyers for such assets due to the issues discussed above, RSAs may wish to consider such policies designed to mitigate these kinds of risks and make this recovery option more pragmatic and viable.

An additional complexity of PSIA model can be seen in unrestricted PSiAs. Such accounts are commingled and may be mixed with the bank's own funds. A purchasing entity would effectively become the *muḍārib*, and would liquidate the current *muḍārib*'s position. A prerequisite to this, however, would be properly audited records of the contribution into the fund from the bank and the contribution from the IAH; and, subsequently, what portion of the assets are owned by the bank. The purchase price should only, therefore, buy out the bank's share of assets. (However, if there is any perceived goodwill in the business unit, this can also be factored in, though this is unlikely in a distressed sale.) Such a bifurcation of these commingled funds would require the consent and agreement of the IAH. Under normal circumstances, IAH may want to perform their own due diligence on a potential new *muḍārib*. In a stress event, there would be limited or no time to carry this out and the IAH's main concern may well be the safeguarding and continuation of their portfolio.

RSAs may consider the following with regards to PSIA sales as recovery options: (A) a requirement (if not already in existence) that all banks have properly audited records showing how their funds are commingled with IAH funds in an unrestricted PSIA, and what portion of the assets are owned by whom; (B) contractual insertions being required in PSIA contracts that given IAH consent to novate or transfer to a suitable new *muḍārib* in the event of a

predefined stress; and (C) policy guidance regarding effectuation of PSIA business unit sales to non-bank financial institutions (conventional or Islamic).

3.4.1.1.3 Intragroup Support

Banks and other IIFS are generally part of larger group structures. In banking groups, it is usually expected that one part of the group cannot fail without also bringing down the whole group. Observations from the GFC focused on how much support group members should offer subsidiaries and affiliates who were facing stress.⁵⁵

There are different models for how banking groups manage their liquidity and capital; this can be either centralised (i.e. in the parent) or decentralised (every subsidiary is responsible for its own capital and liquidity as per its local market). Variations include models isolating non-regulated businesses from regulated businesses. In a stress event, a subsidiary may look to its group/parent for support. There are various ways in which such support can be given; conventional groups may use loans (senior or subordinated), bond swaps, repo agreements, letters of credit (LCs) and equity injections, among others.

For an Islamic bank, there are two key areas of consideration: (a) under the Sharī'ah, the nature and type of support structures and contracts that are permissible (and their effects); and (b) the complexities of having an Islamic subsidiary that is part of a conventional banking group. These areas will both be considered in this section, as intragroup support can be an important recovery option in an RRP.

In terms of structures and contracts that can support a group member or subsidiary, a conventional loan that charges interest is not permissible. Islamic groups may use a *qarḍ ḥasan* facility generally to provide liquidity downstreaming to a subsidiary. The *qarḍ* has been defined under IFSB-1⁵⁶ and by the AAOIFI in its Sharī'ah standard No. 19.⁵⁷ In a stress event, a *qarḍ* may also be used to provide liquidity support to a group member. There are various issues that are not entirely resolved. For example, can a *qarḍ* be subordinated to ensure a greater level of loss absorbency? For discussion on this, the *takāful* sector has debated the matter in light of the practice of *takāful* operators (TOs) frequently covering deficits in the risk participation fund through means of a *qarḍ*. There are differences of opinion, as summarised

⁵⁵ Basel Committee on Banking Supervision, International Organization of Securities Commissions and International Association of Insurance Supervisors (2012), *The Joint Forum: Report on Intra-Group Support Measures* (February).

⁵⁶ A non-interest-bearing loan intended to allow the borrower to use the loaned funds for a period with the understanding that the same amount of the loaned funds would be repaid at the end of the period.

⁵⁷ *Qarḍ* is the transfer of ownership in fungible wealth to a person on whom it is binding to return wealth similar to it.

by Onagun.⁵⁸ Arguments against contractual *qarḍ* subordination hold that it would take on the characteristics of an equity structure. Opinions will differ among jurisdictions and Sharī'ah experts on this matter. For RSAs, there should be awareness of the risk being placed on the *qarḍ* provider and an assessment of any possible group contagion. Subordination (if allowed) will make the recovery option more akin to capital investment, whereas normal *qarḍ* provisions, which establish the provider as a normal unsecured creditor, are seen more as a bridge funding tool (depending on maturity).

Two possible group support mechanisms that could be utilised by a subsidiary/group member are commodity-vector *murābaḥah* and *kafālah bi al-ajr* (guarantee with fee) structures.

A commodity-vector *murābaḥah* (e.g. metals or palm oil) may constitute a *tawarruq*, in the opinion of many scholars. Again, the actual usage of *tawarruq* will vary in terms of permissibility from jurisdiction to jurisdiction. It is, however, a liquidity support mechanism. Such contracts, if pre-agreed and with defined trigger points, can provide funding support to an entity in stress and help it to recover its position.

There are also Sharī'ah discussions and debates as to whether a fee can be charged for a guarantee. It should be noted that the guarantee, if used, is primarily to obtain the benefit of the parent's superior credit rating, thereby making capital raising less cost prohibitive for the subsidiary. The aim with such a mechanism is to place less reliance on the parent/group for support, as the subsidiary itself has been able to manage and raise funds independently. Such a tool is a longer-term structural (in most cases) form of intragroup support.

Equity injections into a failing subsidiary by a parent are probably the most permanent and robust form of intragroup support. However, these constitute a permanent drain on resources for the provider, are legally complex to arrange, and are infrequently available as an efficient mechanism.

Again, this is an area where RSAs will need to devote careful consideration when constructing their recovery and resolution frameworks. Possible solutions may be Sharī'ah board members discussing the use of conventional financing methods specifically to help save an entity in stress (using *ḍarūrah* principle). Another consideration may be where a conventional parent has an Islamic subsidiary, it needs to consider using Sharī'ah-compliant downstream support methods. Such structures will not be used in business-as-usual circumstances by any conventional entity; however, RSAs may wish to explore having them as a "back-up" recovery mechanism in the wider RRP framework.

⁵⁸ *Solvency of a Takāful Fund: A Case of Subordinated Qarḍ*.

3.4.1.1.4 Summary

The analysis of recovery tools that are well known and used in RRP has revealed a number of issues with regards to Sharī'ah compliance and the actual usage of these recovery options in the IIFS context. The aim of this analysis was not to draw a picture that suggests RRP for IIFS is inconceivable or excessively burdened, by structural issues or otherwise. As echoed in the *World Bank Legal Review* (Vol. 5), Islamic banking requires a specialised insolvency regime that reflects the nature, contracts and structures used by Islamic banking. Similarly, RRP frameworks for financial systems that contain both Islamic and conventional banks must be cognisant of the needs, requirements and characteristics of both sectors. As mentioned previously, the recovery module of an RRP is designed to act as a plan of action – a predefined and pre-arranged set of tools that can be operationalised in stress situations and where analysis has already been undertaken to gauge how effective the actions may be. It allows a bank to attempt recovery of its own position, which is always more desirable than effecting a resolution (and, further along the line, a liquidation). By being aware of the issues that may exist with traditional recovery options for capital and liquidity, RSAs can engage key stakeholders in discussions early to work out what an effective recovery strategy may look like for their IIFS. It is this level of preparedness which RRP frameworks and principles such as the FSB's Key Attributes aim to ensure.

3.4.1.2 Resolution Tools

The previous section considered and analysed recovery tools in the Islamic banking context. This section will examine the resolution powers that an RSA/resolution authority possesses, and attempt to apply them to an Islamic bank (although these powers may also be applicable to other financial institutions). It will assess weaknesses, gaps and structural issues and, where possible, offer some suggestions on how to compensate for these. The aim of this section, as with the previous one, is to make RSAs aware of the specific issues that may arise in an Islamic bank resolution and how methods of addressing these issues can be incorporated into a robust resolution framework.

As per the BoE's supervisory statement,⁵⁹ resolution planning is required by banks themselves (as part of the RRP) to ensure that an orderly wind-down can take place – one that minimises the adverse impact on the wider financial system. The FSB's Key Attributes lists a range of powers that a resolution authority should possess. This section will focus on some key powers in the Islamic context – namely, bail-ins, asset transfers and bridge banks.

⁵⁹ Bank of England, SS19/13, *Resolution Planning* (December 2013).

3.4.1.2.1 Bail-ins

The aim of a bail-in is to stabilise a failed bank and ensure that it can continue to provide critical functions, without any immediate need to split up the bank. This may be achieved using the firm's own resources; that is, the interests of existing shareholders can be cancelled, diluted or transferred, and the claims of unsecured creditors are written down sufficiently to absorb the losses incurred. Creditor claims are converted into equity to recapitalise the firm.

First and foremost, a resolution authority (whether this is the central bank or another entity) will need the legal ability to enforce bail-ins. From a regulatory capital perspective, some capital-qualifying instruments may already have bail-in features, such as contingent convertible (CoCo) bonds in the conventional sense. There are no "CoCo" *shukūk* currently issued (Thomson Reuters⁶⁰). As per IFSB-15, Additional Tier 1 capital should be in the form of perpetual maturity *mushārahah shukūk*.⁶¹ *Mushārahah* represents a joint venture/partnership model. Importantly, such a structure is a general obligation (usually secured against the bank's business wholly) and therefore does not require specific underlying assets. The International Sharī'ah Research Academy for Islamic Finance (ISRA) has stated that, from a Sharī'ah perspective, shareholder equity (Common Equity Tier 1, or CET1) and *mushārahah* AT1 *shukūk* can be treated *pari passu* already. In other words, the *mushārahah* AT1 *shukūk* ranks equally with the shareholders of the originating IIFS. *Mushārahah* is compared to "Class B" non-voting shares in this instance.⁶² From a resolution powers perspective, bailing-in such *shukūk* presents no problems. From a Sharī'ah perspective, so long as the legal powers exist for the resolution authority to enforce a bail-in, there are unlikely to be any conflicts with Sharī'ah. The popularity of *shukūk* termed as *mushārahah* has declined over time. However, there have been a number of AT1 qualifying issuances by Islamic banks that use a *muḍārahah* or *wakālah* contract, but retain many of the loss absorbency and permanency features of *mushārahah* as they are structured on the whole business/balance sheet of the firm.

The bail-in power of debt write-downs may be difficult in the Islamic context. As discussed at the beginning of this chapter, while debt forgiveness is regarded very positively under the Sharī'ah, voluntary debt forgiveness can only be effected with creditor consent. Debt cannot be extinguished except through voluntary write-down (or repayment). It is unclear, therefore, whether the bail-in concept of a mandatory debt write-down by a resolution authority is

⁶⁰ Thomson Reuters Islamic Finance Gateway (19 December 2016). *Additional tier one shukūk show way towards the first CoCo shukūk issuance*.

⁶¹ IFSB-15: *Revised Capital Adequacy Standard for Institutions offering Islamic Financial Services [Excluding Islamic Insurance (Takāful) Institutions and Islamic Collective Investment Schemes]*, p. 8.

⁶² ISRA (2013). *Research Paper: Instruments for Meeting Capital Adequacy Requirements under Basel III: A Sharī'ah Perspective*.

compatible with Sharī'ah.⁶³ Similarly, and as discussed previously, there is also an incompatibility with haircuts/sale of debt at less than par value under Sharī'ah, especially where there is a debt-to-equity conversion that is done at a discount to face value. This is another area where more discussion and clarity are required, from a Sharī'ah perspective. As with previous recommendations, this paper urges RSAs to engage their Sharī'ah scholars and boards in discussions around this matter when considering resolution powers and their applicability to Islamic banks.

The ISRA paper on *shukūk* discusses write-downs of structures such as *murābaḥah* and *ijārah* facilities. It states that write-down via a *wa'd* or clause insertion in the initial contracts to accept a write-down at the point of non-viability may raise Sharī'ah issues due to its possible resemblance to combining a sale with a loan or combining *ijārah* with a loan. In both scenarios the willingness of the investors to write down their debt in the case of *murābaḥah* or write down their ownership stake in the *ijārah* assets could resemble a loan.⁶⁴ However, for the proponents of such an approach, this mechanism is consistent with the analysis that it is the creditors themselves who must agree to a write-down under Sharī'ah; it cannot be done or imposed unilaterally by a third party. From a policy perspective, such an action would require banks and investors/creditors to think about default events from the inception of the relationship. There would need to be specific thinking around when non-viability actually occurs (its breach levels) and how much write-down is to be accepted. (Are there parameters, or is it left wholly to the resolution authorities' discretion with regards to amount?) From a practical vantage point, some creditors may not wish to accept such a clause, while some may. How would such a scenario then be operationalised?

The key take-away here is that, given the complexities the Sharī'ah adds to generally accepted RRP principles, these discussions need to take place before a resolution happens (usually before a contractual relationship is established). Sharī'ah boards may also be part of this discussion in terms of advising the resolution authority. However, there need to be pre-emption and actions taken early in the relationship process in order for many of these issues to be addressed.

3.4.1.2.2 Asset Transfers and Bridge Banks

This chapter has already discussed asset sales as a recovery option by a bank in a stress scenario, and some of the issues and Sharī'ah considerations that arise in this regard (given

⁶³ IMF (2015). Working Paper: *Resolution Frameworks for Islamic Banks* (November).

⁶⁴ Examples of this can be found in some Malaysian IIFS *shukūk* issuances that are capital qualifying. Maybank Islamic, for example, has a Tier 2 Capital Subordinated *shukūk* that is *murābaḥah* structured.

the asset-side make-up of Islamic banks' balance sheets). From a resolution perspective, an authority should have the power (as per the FSB's Key Attributes) to transfer assets from a failed bank to another bank and to allow their continued operation. The sale of assets is the bank's own attempt to recover and safeguard itself; asset transfer is the resolution authorities' attempt to ensure that a bank which is now failed causes minimal systemic disruption (by identifying and carrying out asset transfers to solvent institutions). A bridge bank is effectively an entity set up by the resolution authority or central bank to take over and maintain the banking services of a failed bank, until an appropriate acquirer is identified.

Many of the issues already discussed with regards to asset sales in the Islamic banking context are the same for this resolution power – namely: debt haircuts, lack of IIFS as purchasers, conventional banks (or even non-banks) acting as the purchaser, and the complexities presented by a PSIA (commingled) business unit. These issues will impact an asset transfer and a bridge bank model in the same way. Novation of PSIA *muḍārib* contracts will need consent from the IAH as well.

A potential way of dealing with the issue of debt transfer to a new assignee (a solvent bank or a bridge bank) may be found in the concept of *hiwālah*.⁶⁵ This concept allows a debtor to assign his, her or its obligation to another debtor, so long as that assignee party is solvent (without the creditor's consent).⁶⁶ This could work on both sides of the balance sheet; liabilities (where the failed bank is the debtor) and assets (where the clients are the debtors) could include an insertion in the contract that allows for a *hiwālah*-type transfer to take effect to an appropriate assignee (third-party bank or bridge bank) as per the resolution authorities' decision and best judgment. Having such a clause already included in contracts may help streamline and quicken the general asset transfer process at the point of failure. Legal clarity would, of course, be required with regards to the trigger points that allow such a clause to take effect.

The protection of party rights in accordance with applicable Sharī'ah contracts is a key issue in any novation/transfer process. Prior assessment by IIFS may be required in jurisdictions to allow them to identify which types of contracts (including combination/hybrid structures) need prior consent for a sale, and whether this consent can be sought at contract inception (caveated with defined triggers, etc.). The process of moving a business to a bridge institution would need to be carried out quickly in a resolution scenario, and seeking the consent of various parties at that stage is unviable. These issues need to be addressed, with legal

⁶⁵ R. Hassan and A. Yusoff (2007). The Resolution of Islamic Commercial Disputes in Malaysia: Courts, Mediation and Arbitration, *Asian Journal on Mediation*, 3, 17–27.

⁶⁶ This view is adopted more so by the Ḥanbalī school of jurisprudence.

mechanisms/clauses inserted, at the time of entering into the relevant contracts and transactions for such powers to be successful and compliant with the FSB criteria.

3.4.1.2.3 Summary

From the analysis and literature review on resolution powers, it is interesting to observe that, with regards to bail-in, Sharī'ah structures that are emphasised by the IFSB for their loss absorbency capacity (*mushārahah şukūk*) are already regarded as being AT1 capital, while from a Sharī'ah perspective they may even be coterminous with CET1. In such instances, a resolution authority needs only the legal power to convert them into equity from the secular perspective (as with the conventional market). There are, however, ongoing Sharī'ah issues with regards to debt write-downs, asset transfers and bridge banks. As previously discussed, these issues require further thought from both a Sharī'ah perspective and a national/RSA policy perspective.

It has been repeated throughout this paper that early engagement with Sharī'ah boards/committees is a paramount necessity in order to help resolve many of the noted issues and to ensure Sharī'ah compliance throughout the recovery/resolution process. An RRP framework for IIFS should, therefore, contain specific governance requirements whereby the requisite Sharī'ah authority is involved in the IIFS' recovery and resolution planning from the outset. This is particularly important where a group resolution plan is being drafted and the apex institution is conventional with Islamic subsidiaries. The Sharī'ah board/committee designated could be leveraged from the existing Islamic entity, or a new one could be formed altogether. Importantly, the framework in this regard must ensure that all needed information is received by the board/committee both in a timely manner and with full unimpeded access.

Since each jurisdiction has unique features of its Islamic banking sector and of its Sharī'ah compliance, RSA of individual jurisdictions should be responsible for formulating recommendations that can be employed by the Sharī'ah boards at institutional and/or national levels. While this paper is not in a position to propose recommendations that can be applicable to every jurisdiction, it can propose several steps that can be undertaken by the concerned RSA in order to formulate such recommendations. The first step is for the RSA to facilitate the engagement of the centralised Sharī'ah board in the process of creating a recovery and resolution plan for Islamic banks. This may involve, among other actions, formulating guidelines regarding the structuring of contracts in a manner that does not restrict the execution of recovery and resolution tools at the time of stress, the circumstances under which the principle of *pari passu* treatment could be departed from, and the available Sharī'ah-compliant recovery and resolution tools. A second step is to facilitate the engagement between

the centralised Sharī'ah board and the Sharī'ah boards at the institutional level. Based on these engagements, general guidelines and recommendations can be issued by the centralised Sharī'ah board in regards to the RRP. These recommendations can then be employed by the Sharī'ah boards at the institutional level to formulate their own RRP, which should be in line with the overall guidelines and recommendations.

A key consideration from the FSB's Key Attributes that is critical in the context of resolution (and, to a lesser extent, recovery) is the concept of "no creditor worse off than in liquidation". This states that whatever resolution strategy and mechanism is applied to a failing IIFS, the end result must be that no creditor is in a worse position than they would have been if the normal liquidation process had taken place. In the context of the IFSI, this can become more complex as the resolution authority will first need to understand what each creditor's position is in liquidation as a reference point. This is in itself an overarching challenge (as this paper discusses) given the legal and structural grey areas and the diversity of liquidation systems. When considering resolution strategies as part of the wider recovery and resolution frameworks, RSAs should be mindful of this concept. This paper contains some assessment of actual liquidation for Islamic banks and structures; however, jurisdictional (legal) nuances will need to be considered.

3.4.1.3 PSIAs and Insolvency

This chapter has discussed the key issues regarding recovery options and resolution tools for Islamic banks. The final section, dealing with the banking sector, will look at liquidation, and in particular at PSIA treatment during a liquidation. The capital markets section of this chapter will continue to discuss *ṣukūk* issues in resolution/insolvency and this will overlap with banking (from a capital components perspective).

PSIAs represent a unique Islamic banking product with a number of balance sheet and legal complexities. PSIAs are investment products, normally structured using *muḍārabah*, where the customers (IAH) act as *rabb al-māl* (capital provider) and the bank offers its management services as a *muḍārib* (service provider). There is a specified profit-sharing ratio between the two parties and, importantly, no guarantee of capital or of profit to the IAH given that this is an investment product. PSIAs may be restricted (specific investments only and segregated client accounts) and unrestricted (funds may be commingled with the bank's own funds). The issues arise from a balance sheet perspective due to displaced commercial risk.

PSIA products often compete with conventional time deposits for customers. As a result, Islamic banks may conduct profit smoothing using a number of methods.⁶⁷ Profit smoothing is a technique used by IIFS to mitigate liquidity runs; the IIFS will attempt to offer a rate of return to its IAH that is competitive and largely in line with prevailing market rates (i.e., on time deposits of a specific duration). The IIFS may also cushion any capital losses faced by IAH. This can commonly be done through the creation of reserve funds that receive a surplus share of investor and IIFS income (generated from the investments) and are utilised to “top up” IAH return, or to protect their capital should the PSIA investments yield below the market rate/experience a loss. Other techniques – such as forgoing the IIFS share of income – can also be used. The result is IIFS taking on the risk of both capital preservation and profit guarantee (in the manner of a normal time deposit) for an investment product. This can cause complexities with regards to whether PSIAs are off-balance sheet or on-balance sheet (or somewhere in the middle) and asset ownership (where commingling of funds with bank funds is done).

This section will focus on the treatment of IAH in an insolvency and the treatment of the profit equalisation reserve (PER) and investment risk reserve (IRR) funds in an insolvency scenario. It will attempt to provide some guidance on how IIFS can ensure a degree of Sharī‘ah compliance through the bankruptcy and insolvency procedure.

3.4.1.3.1 Treatment of IAH in an Insolvency

The Financial Stability Board stated previously that there is a divergence in how regulators treat PSIAs (some as investment accounts, some as deposit accounts) and that, importantly, there has been no real test of this in an insolvency or bankruptcy proceeding.⁶⁸ In conventional terms, it may be difficult to place PSIAs in the creditor hierarchy. Usually, parties who assume the least risk occupy a more preferred position in the payment hierarchy table (i.e. secured creditors). It can be argued that IAH have contracted into an investment product and so should bear the full risk of that decision, but not of other bank risks. However, the reality is, as suggested by the practice of profit smoothing, that IAH may well be looking for Sharī‘ah-compliant products, but they are not looking specifically for the risks associated with a *muḍārabah*⁶⁹ structure.

⁶⁷ IFSB Guidance Note 3, *The Practice of Smoothing Profit Payouts to IAH*, details these techniques.

⁶⁸ G20 Financial Stability Board (2013), Press Release: *Comments Received on the FSB Consultative Document on Effective Resolutions of SIFIs*, DFSA Draft Comment Letter to the FSB (May).

⁶⁹ A *muḍārabah* contract is a partnership between work and capital where the capital provider is exposed to the losses of its capital, while the provider of work is exposed to loss of time and effort. In the PSIA context, the IAH provides capital, which is invested by the IIFS as partners. The IAH agrees to bear capital losses that may be incurred. A profit-sharing ratio is agreed between the two parties.

IAH have invested in specific assets, which should be identifiable (although there is an added complexity for unrestricted PSIAs, where there may be ownership by the bank as well). If, despite not being bank assets or liabilities, the IAH becomes involved in the bankruptcy or insolvency process, and depending on what these assets are, they can be sold at the best attainable price (likely a haircut, given the distressed nature of the sale) and so long as the ownership proportion of the asset can be identified in bank records, an IAH will be entitled to that portion of the final sale. This will undoubtedly result in capital depreciation. A further complication is added where PSIAs have been taken in to fund the general assets of the bank – that is, home/vehicle financing, etc. Such assets could be debt in nature (*murābahah*) and the issue of sale or transfer at less than par arises again.

Abdelhady⁷⁰ argues that, regardless of what the nature of the PSIA is from a risk perspective, those who invest in IAH are retail depositors looking for a Sharī'ah alternative to interest-bearing deposit accounts.⁷¹ From a policy level, she argues, there should be a statutory claim created for IAH to be able to claim back their PSIA funds in proportion to what they have invested. This could be possible from a Sharī'ah perspective, she says, given public interest arguments. She also proposes that PSIA assets should be ring-fenced within a bank to ensure their isolation and protection from other claimants. This can be understood in a secular legal context where an insolvency practice may not necessarily recognise the investment nature of the PSIAs (obfuscated by the profit-smoothing techniques) and regard them as bank-owned assets.

This approach moves away from the underlying legal principles of what a PSIA is and instead focuses on wider policy concerns. As seen in many jurisdictions, the emphasis around RRP and insolvency is to protect the retail depositors. Political sentiment favours the retail investor and the protection of that investor. In this regard, protecting IAH to the full amount invested can be understood from a protection/safeguarding level. Such a distinction, however, is a matter for each RSA's policy and political backdrop with regards to retail bank customers. Whether accrued profits should be protected (especially if the investment has a long maturity – e.g. 10+ years) is another complexity requiring an RSA policy decision. Safeguarding the capital and some, if not all, of the profits would mix fixed-income and equity risk profiles. It could place PSIAs in an advantageous position as compared to conventional savings accounts and create its own type of moral hazard. This paper urges RSAs to apply a consistent legal and policy treatment as far as possible.

⁷⁰ H. Abdelhady (2014). Consumer-orientated Insolvency Risk Allocation in Islamic Retail Profit Sharing Investment Accounts, *Butterworths Journal of International Banking and Financial Law*, 29(4),

⁷¹ It should be noted that this represents an economic reality, though not a legal/Shari'ah one.

Another issue that should be considered here is that of deposit insurance. Deposit insurance protections vary from one jurisdiction to another. Some jurisdictions may have a Sharī'ah-compliant deposit insurance scheme, and some may not. Those banks with a local SCDIS may also include coverage of PSIAs, whereas those without a SCDIS may still use conventional deposit insurance and also cover PSIAs. There are Sharī'ah debates as to whether any PSIAs should be afforded SCDIS given their *muḍārabah* risk-sharing nature.⁷² Where it does exist and the coverage extends to the outstanding amount of capital invested, then perhaps nothing further is needed from a policy perspective to safeguard the interests of the IAH (assuming the SCDIS/DIS is properly operationalised). However, if SCDIS/DIS does not provide coverage for the IAH in full outstanding amount, then there will be a need for policy measures to safeguard the interests of the IAH.

Unrestricted PSIA can be more of an issue; the assets may have a proportion of ownership belonging to the bank itself (commingling).⁷³ In a liquidation, the court or judge may look to realise this portion and isolate out the investment funds. It is unclear how this can be achieved without also liquidating and realising the IAH assets (and if these assets include normal retail financing such as home finance, it becomes even more difficult to envisage); such a liquidation may result in an unavoidable capital loss for the IAH. If policy dictates that IAH should not be allowed to suffer any capital depreciation even in bankruptcy or insolvency, then the portion lost by them in such a situation would need to be recovered from the bank in another way. What legal status this accords the IAH, and how it would be entertained by courts across a varied spectrum of legal environments, is extremely difficult to say.

3.4.1.3.2 *Treatment of PER and IRR in an Insolvency*

Profit smoothing through the creation of reserves has been mentioned earlier in this section. An IIFS may create a PER (which contains profits derived from investments that belong both to the bank and to the IAH) that is used largely to give a set rate of return on PSIAs, which rate of return generally falls in line with the prevailing market benchmark. The PER may retain profits from one period of compliant investment for smoothing in a later period. Banks may also create IRR funds (which contain investment profits after the banks' share has been taken and are generally used to cushion the IAH from capital losses).

It would seem that ownership claims on each set of funds should be clear. The profit-sharing ratio can be used to work out how much of the PER fund belongs to the bank and how much belongs to the IAH. The IRR fund is normally wholly IAH owned. However, given the

⁷² R. Wilson (2016). Deposit Insurance in Islamic Banking, *Middle East Insights – Islamic Finance Special* (July).

⁷³ The distinction between an unrestricted and restricted PSIA does not change the actual nature of the PSIA product.

sometimes obfuscated nature of PSIAs (displaced commercial risk being a sign of this), it should be remembered that a bankruptcy or insolvency procedure for an Islamic bank would likely take place in a secular proceeding. It is not clear in this situation that the bankruptcy or insolvency process will recognise the PER and IRR for what it is: profits belonging wholly, or in part, to the IAH. However, if the documentation and internal records are clear, the recognition of the distinction should also be clear. If the legal environment in the relevant jurisdiction regards PSIAs as normal deposit accounts, it may well also decide that the PER and IRR are pools of money that belong to the bank. They may utilise them to pay off creditors as needed and end up depriving the IAH of their profits in the liquidation process.

An area that can help mitigate such an event may be observed through disclosure requirements. The Qatar Finance Centre Regulatory Authority (as well as the Dubai Financial Services Authority) contains the following disclosure requirement in its Islamic finance rulebook:⁷⁴

“f. To whom the remaining balances of any reserves created by the IIFS for profit smoothing (i.e. PER and IRR) should be attributable should a liquidation event occur.”

A requirement such as this, whether included in disclosure, in a contract, or generally recorded by a bank, can help guide a liquidation process to distribute PER and IRR correctly. It would identify specific persons to whom the profits contained in the reserve accounts belong (i.e. the IAH). Further, this may help to resolve the issue of IAH who have decided to end their relationship with the IIFS prior to any insolvency and liquidation occurring. It may be that the funds contain profits that were generated by assets belonging to them in the period where the transfer from IAH profits was made. While this would require a specific form of data record to understand the flows into the funds (and subsequent payments to IAH in future periods), it may ultimately help segregate these reserved profits from being paid out to other (non-IAH) creditors. There is a possibility that some IAH will never receive funds from the PER throughout the tenure of their investment accounts if their earning in years is above-average profit. The standard IFSB-3 recommends that, in the event of liquidation of an IIFS, the PER should be disposed of in accordance with what was agreed upon at the time of establishing the reserves, which commonly would be one of the following: (a) distribution to the existing IAH and shareholders; or (b) donation to charities.

⁷⁴ www.complinet.com/net_file_store/new_rulebooks/q/f/QFCRA_10464_VER1.pdf

3.4.1.4 Conclusion

The aim of this section has been to bring to the surface some of the underlying issues and complexities for both RRP of, and bankruptcy and insolvency involving, an Islamic bank. Many of the issues discussed are still uncertain from the legal and Sharī'ah perspectives because much of the thinking, policy and literature in this area is underdeveloped. This chapter is designed to serve as a guide for RSAs and policymakers to the key issues they need to consider further when developing an RRP framework for IIFS and dealing with insolvency obstacles.

Further policy advice will be summarised in Chapter 6 of this working paper. The issues are legally complex and require careful thought as to how to move forward while ensuring that the Sharī'ah principles that underlie the IFSI are maintained. Particularly with regards to RRP, it should be remembered that the framework acts as an action plan for both banks and RSAs to follow should a stress circumstance or failure occur. This helps to ensure that recovery or a wind-down is done in an orderly manner and with minimal negative impact on the wider financial system. Understanding what the issues are is a key step in fulfilling this aim.

3.4.2 Capital Markets

The Islamic capital markets, much like conventional capital markets, are the medium through which IIFS raise funding (debt, often via *ṣukūk*, or equity), carry out investment activities, and mitigate risk through risk transfer contracts (e.g. *salaam*, profit rate swaps, cross-currency swaps). A discussion of resolution and recovery in capital markets would normally deal with entities that are primarily active in those markets. The classic examples in conventional finance are the broker–dealers who take principal risk onto their own books. These firms are relatively rare in Islamic finance (although Chapter 5 alludes to one investment firm with somewhat similar characteristics). During the GFC, certain money market investment funds structured to maintain a constant net asset value (CNAV) were also problematic, but (for Sharī'ah reasons) CNAV money market funds do not appear to exist within Islamic finance.

The other major class of capital markets entities that would fall to be considered is of those providing financial market infrastructures, especially clearing and settlement. The increased emphasis following the GFC on the use of central counterparties to limit the transmission of shocks through capital markets has led to increased concern about the prudential regulation of those counterparties themselves, and also about how their own resolution and recovery might be managed. However, thinking on this is not highly advanced, even in conventional finance, and the number of central counterparties claiming to operate under Islamic principles is extremely limited. The issues in this area are therefore ones for later work.

In the light of these facts, this section focuses on capital market instruments rather than firms. In particular, it looks at *ṣukūk* in the Additional Tier 1 (AT1) and Tier 2 (T2) capital-qualifying context and examines the issues that may arise with regards to insolvencies that involve these products.

In particular, this section considers creditor hierarchies when looking at AT1 structures (versus CET1) from the Sharī'ah perspective and in comparison to the conventional vantage point. It also considers some of the issues that may arise given the way in which AT1 and T2 *ṣukūk* are currently being structured (whether assets are specified or not) and issued.

A brief definition of the different forms of regulatory capital as per Basel III criteria is provided below:

- CET1 comprises a bank's core capital and includes common shares, stock surpluses resulting from the issue of common shares, retained earnings, common shares issued by subsidiaries and held by third parties, and accumulated other comprehensive income.
- AT1 is defined as instruments that are not common equity but are eligible to be included in this tier. An example of AT1 capital is a contingent convertible or hybrid security that has a perpetual term and can be converted into equity when a trigger event occurs. An event that causes a security to be converted to equity occurs when CET1 capital falls below a certain threshold.
- T2 includes revaluation reserves, hybrid capital instruments and subordinated term debt, general loan-loss reserves and undisclosed reserves.

3.4.2.1 AT1/T2 *Ṣukūk*: Creditor Hierarchies

As mentioned previously in the banking section with regards to resolution powers, IFSB-15 recommends that AT1 *ṣukūk* be in the form of perpetual *mushārah*. As detailed by ISRA, such a structure would rank *pari passu* with CET1 shareholders under Sharī'ah principles. The rationale is that the *mushārah* is a joint partnership structured around the whole business of the bank. The ISRA paper compares such an issuance to Class B non-voting shares. The ISRA paper states that, from a Sharī'ah perspective, the conventional creditor rankings of CET1, AT1 and T2 (for *mushārah*-based) cannot be upheld given the nature of the issuance. Subordination would require some explicit agreement to relinquish rights, which may raise Sharī'ah compliance issues.

This is a double-edged sword, from a recovery and resolution perspective. There will be no Sharī'ah issues in converting the AT1 (or T2, if *mushārah*) to equity. However, the paper

maintains that regardless of conversion by a recovery and resolution authority, these issuances are – from a Sharī'ah principles perspective – coterminous to equity investments (CET1). From a market perspective, AT1 *mushārahah şukūk* will rank at least above the CET1 shareholders. Sharī'ah would, however, rank them equally with CET1 shareholders.

Other equity-like *şukūk* issuances are also used by banks for AT1/T2 – namely, *muḍārahah* and *wakālah*. Structuring such issuances on undefined assets and stating in offering documents that they represent ownership of “all assets of the bank” or “the bank’s business” makes it very difficult to differentiate them from a *mushārahah* issuance under Sharī'ah. The perception issue is also present. Investors and market participants (both Islamic and conventional) place AT1 holders as above CET1 in normal circumstances, and T2 *şukūk* holders as above AT1. However, this creditor hierarchy may be in conflict with Sharī'ah if the T2 issuances take on a *mushārahah* structure given that they would again be treated conterminously with CET1. Some examples of AT1/T2 *şukūk*, their structure and the wording from the relevant offering documents, are detailed in Table 3.4.2.1.1.

Table 3.4.2.1.1 Şukūk Examples (Capital Qualifying)

Issuer	Issuance Name	Capital Qualification	Structure Used	Ownership
Dubai Islamic Bank	DIB Tier 1 Şukūk (2) Limited ⁷⁵	AT1	<i>Muḍārahah</i>	Undivided ownership interest in the trust assets (all of the trustee’s rights, title, interest and benefit, present and future, in, to and under the assets from time to time constituting the <i>muḍārahah</i> assets). The <i>muḍārahah</i> assets are DIB’s general business.
Abu Dhabi Islamic Bank	ADIB Capital Invest 1 Limited ⁷⁶	AT1	<i>Muḍārahah</i>	Undivided ownership interest in the trust assets (all of the trustee’s rights, title, interest and benefit, present and future, in, to and under the assets from time to time constituting the <i>muḍārahah</i> assets). The <i>muḍārahah</i> assets are ADIB’s general business.
Ahli United Bank	Ahli United Şukūk Limited ⁷⁷	AT1	<i>Muḍārahah</i>	Undivided ownership interest in the trust assets (all of the trustee’s rights, title, interest and benefit, present and future, in, to and under the assets from time to time constituting the <i>muḍārahah</i> assets). The <i>muḍārahah</i> assets are Ahli’s general business.

⁷⁵ <https://www.şukūk.com/şukūk-new-profile/dib-tier-1-şukūk-2-ltd-3711/>

⁷⁶ www.londonstockexchange.com/specialist-issuers/islamic/4402r-2012-11-19.pdf

⁷⁷ www.centralbank.ie/regulation/securities-markets/prospectus/Lists/ProspectusDocuments/Attachments/36481/Base%20Prospectus.pdf

Issuer	Issuance Name	Capital Qualification	Structure Used	Ownership
Kuveyt Turk	KT Şukūk Company Limited ⁷⁸	T2	<i>Wakālah</i>	Unclear as to what assets are specifically owned.
Qatar International Islamic Bank	QIIB Şukūk Funding Limited ⁷⁹	T2	<i>Wakālah-Muḍārabah Hybrid</i>	Unclear as to what assets are specifically owned.

The above examples highlight a key issue that is discussed in the ISRA research paper. While *mushārah* is the structure of choice for loss absorbency, certain *muḍārabah* and *wakālah şukūk* (whether AT1 or T2) end up taking on many of the features of a *mushārah* issuance due to their being structured around the whole business/general business of the bank. In such structures, there are no defined assets to which investors can claim ownership (whether beneficial or actual). It is difficult to differentiate under Sharī'ah between them and, as a result, to treat them as other than *pari passu* with CET1 shareholders.

In terms of conversion to equity in a recovery or resolution proceeding, the position of the ISRA paper is that they are equity under relevant Sharī'ah principles. This position would leave conversion to local secular law. Again, this has a mixed impact: structuring *muḍārabah* and *wakālah* around a bank's whole business makes them general obligations of the bank and, as stated already, may place *şukūk* holders on a par with shareholders' equity as the most loss-absorbing form of capital. If, however, these structures do not contain conversion clauses, there may arise a Sharī'ah conflict if CET1 shareholders are subordinated to such AT1 and T2 *şukūk* issuances without any explicit derogations.

The General Council for Islamic Banks and Financial Institutions (CIBAFI) has issued a note on Tier 1 and Tier 2 capital instruments⁸⁰ and discusses the use of CoCo bonds by the conventional market for AT1 and T2 inclusion. The paper notes that CoCo bonds usually have higher risk ratings (from rating agencies) associated with them as compared to normal bonds issued by the same party, most likely due to their conversion/write-down features. Trigger points for such issuances can be adjusted down (for T2) or up (for AT1). Trigger points are a predefined and quantified level of loss at which point the conversion feature of a CoCo issuance from debt to equity actually occurs. An example of this may be a specified capital adequacy ratio (CAR) level being breached (e.g. falling below 7%). The conversion aspects

⁷⁸ <https://www.şukūk.com/wp-content/themes/şukūk.new/>

⁷⁹ www.ise.ie/debt_documents/Prospectus%20-%20Standalone_6bf5dccc-2c07-495c-a001-ecfcd1e2ced7.pdf

⁸⁰ CIBAFI (2016). *Briefing Tier 1 and Tier 2 Capital*, Issue 3 (October).

of such issuances from the Sharī'ah perspective have been discussed, but it is also worthwhile considering write-downs in the context of such *ṣukūk* structures.

A write-down tool is one by which an authority could be given a statutory power, exercisable when an institution meets the trigger conditions for entry into resolution, to write off all equity, and either to write off subordinated liabilities or to convert it into an equity claim. The debt write-down tool can be used in both a going concern scenario and a liquidation scenario. (Many AT1 *ṣukūk* structures already contain details of write-down to zero at the point of non-viability based on the resolution authority's judgment and notification.) In a going concern scenario, bail-in would be used to absorb losses and recapitalise the entity. The entity would then be restructured and maintained as a going concern. In a liquidation scenario, bail-in would be used to wind down the entity.

3.4.2.1.2 *Ṣukūk and Write-down*

Write-down mechanisms would be applicable for equity structures such as *mushārah*, *muḍārabah* and *wakālah* from a Sharī'ah perspective, given that loss of capital is a fundamental equity risk. This presupposes that the contracts are true equity in nature. However, commonly in Islamic finance, such contracts have been used to structure *ṣukūk*, which economically behave and are treated as debt issuances (mimicking bonds). Where asset repackaging takes place, there is no "true sale" to the SPV/*ṣukūk* investors. Ultimately, the *ṣukūk* results in a general obligation claim that the investors will have on the originating entity. Many of these *ṣukūk*, therefore, will have fixed-priced repurchase obligations by the originator at maturity.⁸¹ The repurchase price will be the same as the principal amount of *ṣukūk* issued. To either increase the loss absorbency of a bank in stress, or reduce its liability obligations, the write-down of *ṣukūk* needs to be a reduction from the repurchase price.

A key consideration for the authority responsible for the write-down could be to value the *ṣukūk* more so from its equity nature and to consider goodwill depreciation (given that *ṣukūk* structured on the whole business of the bank could be viewed conterminously in Sharī'ah with equity). This would require a shift in how the *ṣukūk* is priced from its inception (which may have been more in line with debt pricing, for competitive reasons). This may be a method that makes write-downs of such capital-qualifying *ṣukūk* easier to carry out from both a legal and

⁸¹ It is assumed that the asset transfer from the originator to the *ṣukūk* issuer was a true sale, and that, under FAS 29, the asset was and is not retained on the books of the originator, but instead on the books of the *ṣukūk* issuer. The complexities of the analysis are considerable, and beyond the scope of this paper, if either of those assumptions are not realities. In current industry practice, most *ṣukūk* of this type involve asset transfers to the *ṣukūk* issuer that (a) were not true sales, and (b) the retention of the asset on the balance sheet of the originator (although the impact of FAS 29 is not here considered), meaning, in either case, that the bank is the equity holder in the asset, not the *ṣukūk* holder.

a Sharī'ah perspective; however, explicit details of this need to be included in the *ṣukūk* contract from the outset.

A more complex issue may arise with regards to jurisdictions that have debt structures included in capital components.⁸² As mentioned previously in this paper with regards to *iflās*, debt forgiveness can only be done with the explicit consent of the creditor, otherwise the obligation to repay the debt is not extinguishable (absent payment on the debt). Trigger points that result in unilateral write-downs by the RSA/resolution authority may result in Sharī'ah conflicts. Some jurisdictions allow the debt write-downs without the consent of *ṣukūk* holders, and this method subordinates the issuance enough so that it becomes capital qualifying. For jurisdictions that do not allow such write-downs, they argued that explicit consent could be sought from the *ṣukūk* holders at the *ṣukūk* issuance via contract clauses and stipulations detailing write-down mechanisms (by another authority) upon triggers being met. For the proponents of such approach, such given consent, both legally and from a Sharī'ah perspective, constitutes debt forgiveness by the creditor with the explicit consent of the debtor in the case of *murābahah ṣukūk*. As for *ijārah ṣukūk*, it will constitute forgiveness of any ownership claim over the *ijārah* assets. However, the opponents of such an approach point out that the stipulation of write-down mechanisms in debt-based *ṣukūk* structures and *ijārah*-based *ṣukūk* structures may raise Sharī'ah issues, since the overall structure may share similarities with the prohibited practice of combining a loan with a sale or with *ijārah*.

In any case, Sharī'ah scholars and boards should be engaged at the time the recovery and resolution regime is being developed to ensure that acceptable and workable standards are established with respect to write-downs.

3.4.2.2 Summary

This section on capital markets has considered issues around regulatory capital *ṣukūk* in terms of recovery and resolution of the issuer. Following on from the analysis and recommendations for Islamic banks regarding RRP, the key take-away is that there may be conflicts around what the Sharī'ah allows and dictates on conversions, write-downs, haircuts and subordination, and what the generally accepted and currently used recovery and resolution powers are with respect to different components of the entity capital stack.

⁸² Malaysia, for example, treats *murābahah ṣukūk* as T2 capital. Importantly, *murābahah ṣukūk* become general obligations (and so more loss absorbing) because, as a result of the *murābahah* sale, asset ownership has been transferred to the issuer who subsequently has a debt obligation to the *ṣukūk* holders. Similarly, *ijārah ṣukūk* are largely asset based; there is only a beneficial ownership to the repackaged asset. This also results in a general obligation debt owed by the originator to the *ṣukūk* holders. Specific title or recourse to ring-fenced and demarcated assets, despite being more in line with general Sharī'ah understanding, would actually move such *ṣukūk* outside capital components completely due to an inability to absorb wider losses of the bank.

When building a recovery and resolution framework, jurisdictions that have a developed and significant IFSI need to be aware of the issues detailed and highlighted in this paper. A tailored and considered approach to development of the framework can then be formulated. That approach will ensure that Sharī'ah principles are embodied in the framework in recoveries, resolutions and liquidations. This paper does take cognisance of the fact that Islamic banks have not yet reached G-SIB status. However, in some jurisdictions, there are D-SIB entities. Pre-agreed measures to deal with such firms in stress, recovery and resolution scenarios are key to ensuring smooth recovery and/or resolution.

It is suggested that there are needs for (a) legal and contractual clarity at transactional inception, and (b) early engagement with Sharī'ah boards regarding issues of relevance to recovery and resolution of IIFS. Some general suggestions have been given in this section. However, many of the granular issues will require further thinking and clarification. Given that thinking around RRP is nascent for the Islamic market in most places, this is an initial starting point for development of the framework.

3.4.3 *Takāful*

The final consideration for the IFSI is the *takāful* sector. This section touches briefly on solvency issues for the *takāful* model. The issue of subordination of the *qard al-ḥasan* facility has been mentioned in the banking recovery options section of this chapter (intragroup liquidity downstreaming). This is also a key issue for the *takāful* model.

3.4.3.1 *Takāful Overview*

The basic *takāful* model involves separate funds being created. The shareholders will create their own fund, which could be used to help cover any underwriting deficits incurred in the participants' risk fund (PRF). The underwriting deficit (or surplus) arises from the PRF's financial outturn from the risk elements of its business, being the balance after deducting expenses and claims from the contribution income and adding the investment returns.⁸³ The PRF receives contributions from customers of the *takāful* business who are looking for risk coverage. The TO manages the underwriting risk for the participants, usually pursuant to a *wakālah* contract, deriving a fee as *wakīl*. A third fund, the participant's investment fund, may be found in the family *takāful* business model. This is an investment fund containing monies placed into it from the participants (specifically for investment purposes). The TO acts as a

⁸³ IFSB-11: *Solvency Requirements for Takāful (Islamic Insurance) Undertakings*, p. 25.

muḍārib that manages the investments in the investment fund. Importantly, all three of these funds are separate and segregated from each other, each with its own specific purpose.

As mentioned, the TO, in most *takāful* models, is obligated to cover any deficits in the PRF. This is normally done through an interest-free loan (*qarḍ ḥasan*). The *qarḍ* itself is a remedy for Sharī'ah issues that arise from the TO not being allowed to financially benefit from taking on underwriting risk.⁸⁴ The *qarḍ* arrangement is used instead and the *qarḍ* loan must be paid back by the participants' fund from future surpluses. The fee earned by the TO is separate, as it relates to the management of the PRF and not through any exposure to underwriting risk being taken itself. Importantly, from a Sharī'ah perspective, the investment fund should not be utilised to cover any losses/deficits in the *takāful* undertaking should a recovery/resolution scenario arise. Sufficient ring-fencing (legal or structural) is required to safeguard this pool of funds.

Takāful failures, much like their insurance counterparts in the conventional sector, are markedly different from banking collapses. A bank may experience a “run” through concentrated withdrawals of deposits during a stress period (whether idiosyncratic, market-wide or both). Inability to meet these withdrawal obligations, especially during a time when asset sales may be difficult and have to be carried out with severe haircuts, can lead to insolvency. A bank can also fail due to key balance sheet uncertainties on the asset side (i.e. whether the financing will be repaid). An insurance firm and a *takāful* undertaking will not generally experience a “run”, given that the participants cannot simply ask for the return of their contributions. Similarly, with regards to a family *takāful*, early termination rights are likely to come with penalties and disadvantageous terms. A *takāful* undertaking can be severely impacted, however, due to certain events that cause very high claims payouts to be made which cannot be covered by the accumulated assets of the policyholders' risk fund or by the TO's *qarḍ* facility. The collapse of a *takāful* company will therefore be a slower event than that of a bank. While there are, of course, ensuing issues such as participants being unprotected for a period and claims being unmet, it is likely that regulators can deal with such scenarios over a longer time period than in the case of a bank failure.

3.4.3.2 Capital Standards Applicable to *Takāful*

The International Association of Insurance Supervisors (IAIS) issued its Risk-based Global Insurance Capital Standard consultation document in mid-2016. Section 5 of the document outlines the criteria for qualifying capital resources in an insurance company, based on

⁸⁴ S. Archer, R. A. Abdel Karim and V. Nienhaus (2009). *Takāful Islamic Insurance: Concepts and Regulatory Issues*, Singapore: John Wiley & Sons.

permanency and loss-absorption criteria. An overview of the different capital tiers is provided below.

Key Principles	Tier 1 Unlimited	Tier 1 Limited	Tier 2 Paid-up
Loss-absorbing capacity	Absorbs on both a going concern basis and in a winding-up	Absorbs on both a going concern basis and in a winding-up	Absorbs losses in a winding-up
Level of subordination	Most subordinated (i.e. is the first to absorb losses); subordinated to policyholders, other non-subordinated creditors, and holders of Tier 2 capital instruments	Subordinated to policyholders, other non-subordinated creditors, and holders of Tier 2 capital instruments	Subordinated to policyholders and other non-subordinated creditors
Availability to absorb losses	Fully paid-up	Fully paid-up	Fully paid-up
Permanence	Perpetual	Perpetual – no incentives to redeem. Issue may redeem at any time after a minimum of five years after issuance or repurchase at any time, subject to prior supervisory approval.	Initial maturity of five years – may have incentives to redeem but first occurrence deemed to be “effective maturity date”.
Absence of both encumbrances and mandatory servicing costs	Internationally Active Insurance Group (IAIG) has full discretion to cancel distributions (i.e. distributions are non-cumulative). The instrument is neither undermined nor rendered ineffective by encumbrances.	IAIG has full discretion to cancel distributions (i.e. distributions are non-cumulative). The instrument is neither undermined nor rendered ineffective by encumbrances.	The instrument is neither undermined nor rendered ineffective by encumbrances.

This criterion closely aligns to the features of CET1/AT1/T2 capital under the Basel III regime for banking. The issues around *qarḍ* subordination and single-entity views of the *takāful* understanding discussed below should be read in the context of these capital requirements.

3.4.3.3 Qarḍ Subordination and Conversion

A key issue in the recovery and resolution context relates to the treatment of the *qarḍ* facility. Sharī'ah generally does not allow the *qarḍ* to be subordinated to other creditors. It is a loan

(albeit without interest), and given the requirement that similarly situated creditors must be treated *pari passu* with other loans (an issue we have examined in the banking model with regards to capital-qualifying *ṣukūk*), contractual subordination from the Sharī'ah perspective is difficult, although straightforward enough in most secular legal frameworks. This treatment is somewhat inconsistent with the desired effect of the *qarḍ*, which is to avoid insolvency by covering deficits. Subordination would seem to be a prerequisite for this to happen. Without it, TOs may face problems with regulatory solvency requirements.⁸⁵

We may consider here some options for the *takāful* model to use in dealing with solvency and loss absorption from the banking sector.

IFSB's standard on solvency requirements for *takāful* undertakings⁸⁶ sets forth some guidelines on the capital resources eligible to be admitted for solvency purposes. The framework mentions two factors to account for in determining the eligible capital resources for solvency assessment. These are: (a) the existence of adequate unencumbered capital in the shareholders' fund; and (b) the need for capital elements and investment instruments to be Sharī'ah-compliant. The *qarḍ* facility is detailed in this standard as a reflection of what was/is industry practice. One option that could be explored with Sharī'ah experts is that of treating any part of the *qarḍ* facility that has been drawn down as a *qarḍ* as being donated to the PRF to the extent that is necessary in order for participants' claims to be met in the context of a severe stress event.⁸⁷

This is to say, should certain trigger points/thresholds be hit with regards to a deficit in the risk participation fund and its potential insolvency, a resolution authority has the legal and regulatory power to write down the drawn-down amount of the *qarḍ*. The important factor here is that the drawn-down amount of the *qarḍ* in a business-as-usual operating environment remains as an interest-free loan and carries no subordination. Only in a specific stress scenario does the subordination occur. Such a remedy would require (as has been mentioned in other parts of this paper) early engagement and discussion with Sharī'ah scholars as to the overall aim of allowing such derogation from normal Sharī'ah principles (i.e. helping to recover and restructure the undertaking).⁸⁸

⁸⁵ Under Solvency II, for example, insurers will need enough capital to have 99.5% confidence that they could cope with the worst expected losses over a year.

⁸⁶ IFSB-11: *Standard on Solvency Requirements for Takāful (Islamic Insurance) Undertakings*.

⁸⁷ IFSB-11, p. 14.

⁸⁸ Another possible approach is that of converting the *qarḍ* into equity for loss absorbency purposes. However, such an approach may not be a viable solution in addressing insolvency issues for *takāful* undertakings in view of the fact that the shareholders' fund should be treated separately from the PRF and participants' investment fund at all times. Moreover, it remains unclear what kind of equity the shareholders own in a *takāful* fund based on the concept of *tabarru'*.

3.4.3.4 *Takāful Undertakings: A Single-entity View*

Another consideration can be seen from IFSB-11,, which focuses on the *takāful* undertaking as a single entity. Effectively, the entire *takāful* undertaking is consolidated together and viewed as one entity. Here, “undertaking” refers to a hybrid structure comprising a TO and one or more underwriting funds (PRFs) that are attributable to the *takāful* participants. When calculating a *takāful* undertaking’s solvency position, the distinctive rights and obligations between the shareholders and *takāful* participants require a clear segregation of the PRF from the shareholders’ fund.

The specific legal and accounting treatments of a *takāful* undertaking from jurisdiction to jurisdiction will, of course, impact on the options available to an RSA/resolution authority. The features of capital from both a Sharī’ah and general loss absorbency perspective to satisfy solvency requirements could be leveraged from the Islamic banking model and, in particular, IFSB-15.

3.4.3.5 *Summary*

The *takāful* sector is continuing to deal with a number of issues from both a business growth and a structural perspective. The IAIS is drafting a capital standard for insurers that will likely affect TOs. General solvency issues are ongoing in the industry, and the above (brief) analysis aims to provide policymakers and regulators with some ideas and areas for discussion. An important element from a solvency and resolution perspective is that Sharī’ah scholars be engaged early in discussions to ensure that solutions remain cognisant of Sharī’ah principles.

CHAPTER 4: SURVEY RESULTS AND DISCUSSION

The IFSB Secretariat conducted a survey in December 2016 with the objective of collecting background information on the current state of recovery and resolution frameworks, the legal powers of recovery and resolution authorities in jurisdictions where Islamic finance is present, and the landscape of the Islamic finance industry with regards to issues specific to recovery and resolution and insolvency and bankruptcy.

This chapter provides the results of that survey, and an assessment of the current status of jurisdictions, categorised broadly into the following four sections:

Section 4.1: Overview of IIFS markets, including authorities for recovery and resolution matters.

Section 4.2: General information on current recovery and resolution frameworks, which includes the need for recovery and resolution plans or similar plans for both IIFS and conventional financial institutions.

Section 4.3: Information on the powers of recovery and resolution authorities, which includes discussions on the existing regulatory powers, laws, statutes and regulations to restore solvency in individual financial institutions for both IIFS and conventional financial institutions. This section highlights some of the triggers used by the recovery and resolution authorities in determining whether a financial institution may be subject to corrective actions.

Section 4.4: Descriptions of applicable legal frameworks, which includes discussion of both conventional and Sharī'ah laws and principles and rankings of creditor hierarchies used in conventional regimes and regimes that take cognisance of IIFS.

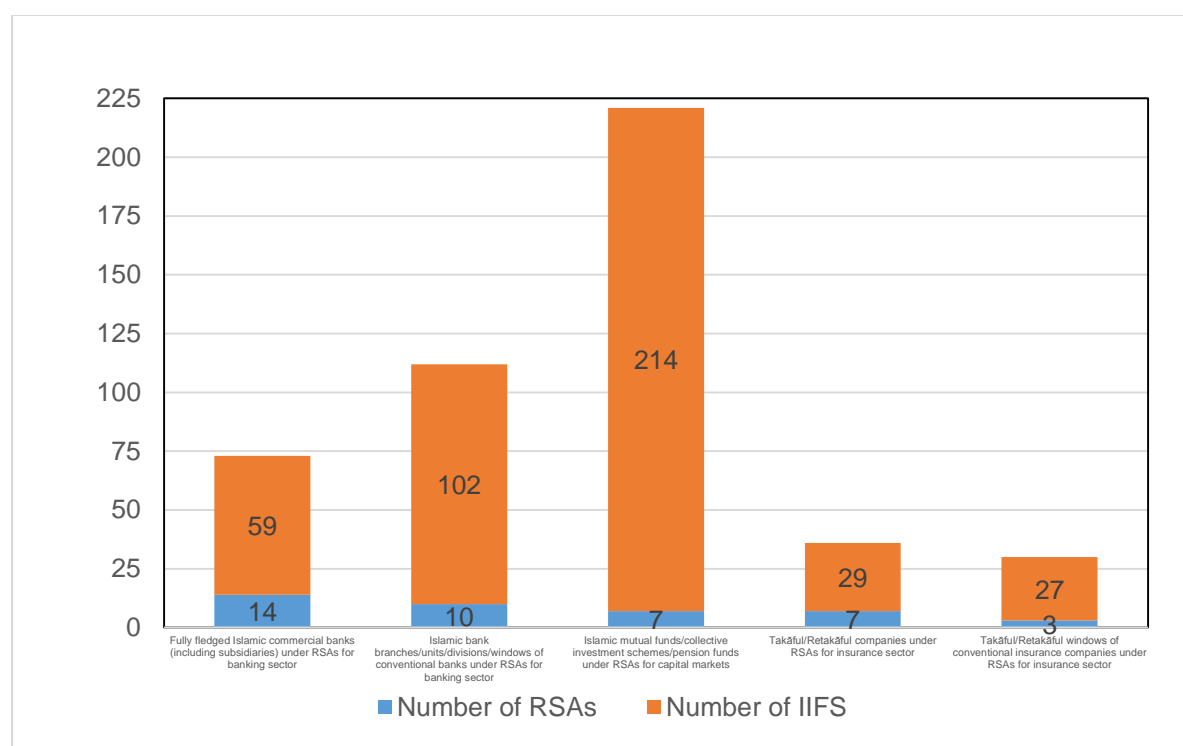
4.1 Overview of IIFS Markets

4.1.1 Respondent RSAs in Jurisdictions

A total of 22 regulation and supervisory authorities (RSAs) from 16 jurisdictions responded to the survey on the three different sectors – namely, Islamic banking, Islamic capital markets and *takāful*. Since some RSAs are regulators for more than one sector, the survey, as a whole, received responses from 14 RSAs responsible for the banking sector, seven responsible for Islamic capital markets, and seven responsible for the *takāful* sector. Two deposit insurance providers, one for the banking and insurance sectors and another only for the banking sector in the respective jurisdictions, responded to the survey.

As shown in Figure 4.1.1.1, the survey compiled data and information regarding 59 Islamic banks (including subsidiaries) and 102 windows, which are supervised by 14 and 10 RSAs, respectively. A total of 214 IIFS in Islamic capital markets are being supervised by seven RSAs. The survey also compiled data and information on 24 *takāful/retakāful* companies and eight *takāful/retakāful* windows being supervised by seven and three RSAs, respectively, for the insurance sector.

Figure 4.1.1.1 Number of IIFS by Categories Being Supervised by RSAs



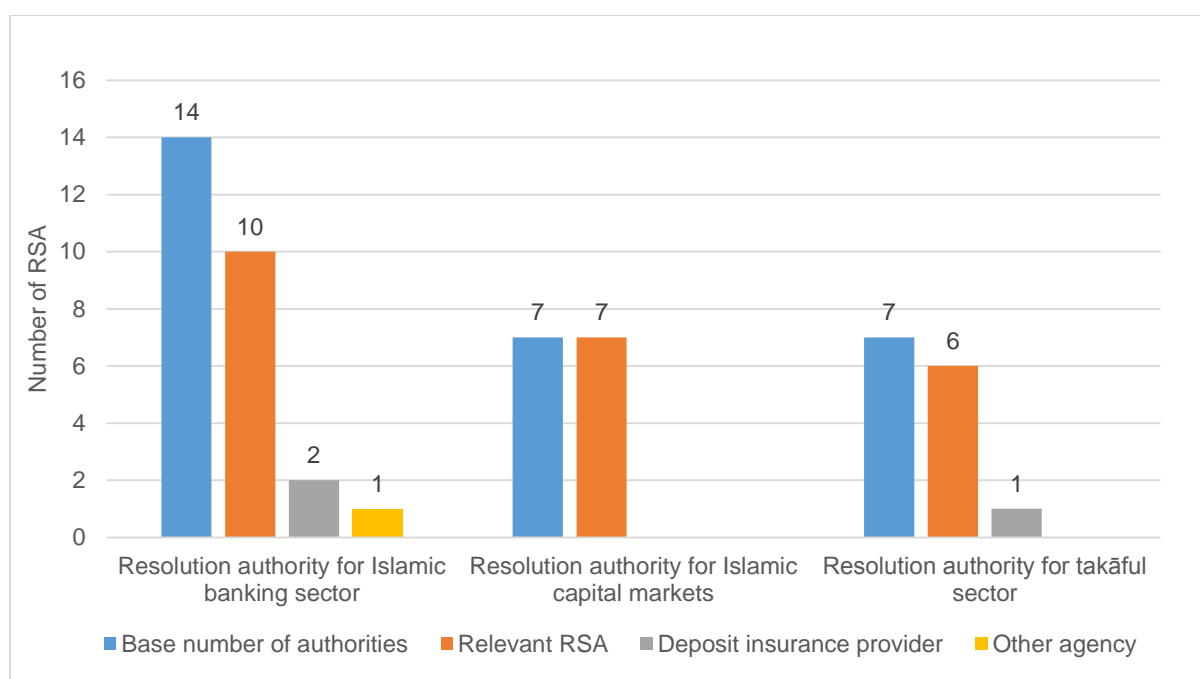
4.1.2 Resolution Authorities in Jurisdictions

In the banking sector, 10 RSAs act as recovery and resolution authorities for both IIFS and conventional banks in their banking sectors. In two jurisdictions, there are deposit insurance providers that are not banking RSAs and act as the recovery and resolution authority both for the IIFS and conventional banks in their respective banking sector. Efforts of one RSA to establish a special recovery and resolution regime for banks (conventional and Islamic) in order to strengthen the recovery and resolution regime (including deposit insurance scheme) are ongoing. In another jurisdiction, a separate agency called a resolution committee acts as the recovery and resolution authority for both conventional banks and IIFS.

In the Islamic capital markets, all of the responding RSAs act as recovery and resolution authorities for both conventional financial institutions and IIFS.

In the *takāful* sector, out of seven responding authorities, six are both RSAs and resolution authorities for their conventional insurance sector as well as IIFS. In the other jurisdiction, the deposit insurance provider acts as a responsible resolution authority both for insurance companies in the conventional insurance sector and for IIFS in the *takāful* sector (Figure 4.1.2.1).

Figure 4.1.2.1 Responsible Resolution Authority by Type of IIFS



Therefore, the resolution authorities both for Islamic and conventional finance are integrated into their relevant RSAs in the relevant sectors. In only three jurisdictions out of 16, the RSA does not act as the sole recovery and resolution authority. In two jurisdictions, the deposit insurance provider (rather than the RSA) acts as resolution authority for both conventional and Islamic banks. In one jurisdiction, a special resolution committee acts as resolution authority (for both conventional and Islamic banks). And in one jurisdiction, the deposit insurance provider acts as resolution provider for *takāful* companies (and conventional insurance companies). In these three jurisdictions, there is either a deposit insurance provider or a separate resolution committee that acts as an independent resolution authority. However, out of 13 jurisdictions where resolution authorities of the banking sector are integrated into their relevant RSAs, two banking RSAs mention that there should be separate resolution authorities other than relevant RSAs. One RSA comments that a central Sharī'ah body could act as a resolution authority for IIFS.

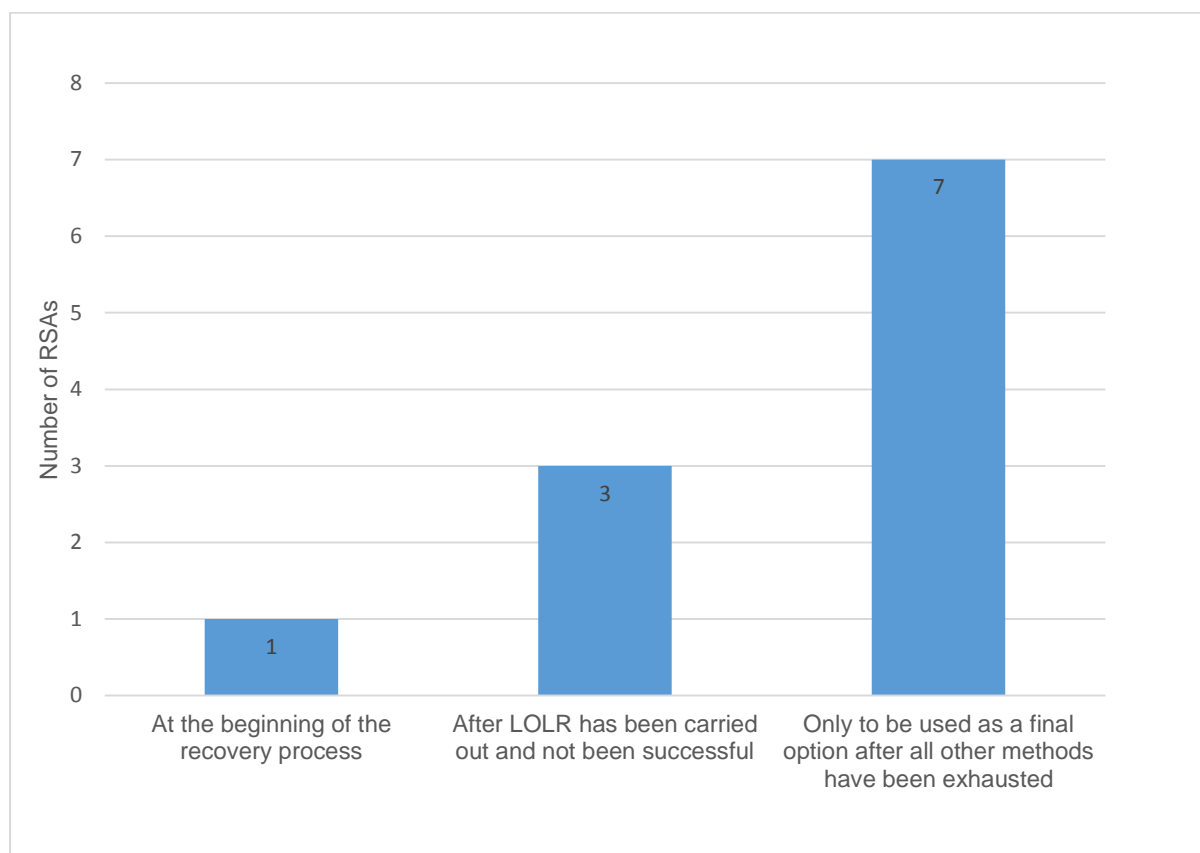
4.1.3 Resolution Authorities for Government Financial Institutions and Bail-outs

Nine out of the total of 11 RSAs mentioned that they have government-owned financial institutions (conventional or IIFS). Each also noted that their responsible resolution authorities have responsibility for both government-owned and private financial institutions in their jurisdictions.

A total of six RSA jurisdictions having government-owned banks in their jurisdictions indicate that the government could provide bail-out facilities to those government-owned institutions should they fail. However, these jurisdictions have a range of approaches in their Acts and practices that include alternatives other than bail-outs. At least three of these six jurisdictions have explicit government guarantee schemes, as provided in their Acts, applicable for the conventional banking sector, including Islamic banks. An Islamic financial institution that is wholly owned by the government is protected by an explicit government guarantee in one of these six jurisdictions, while an Islamic financial institution in the same jurisdiction that is only partially owned by the government is not protected by either explicit or implicit government support.

A total of four RSAs having government-owned banks in their jurisdictions do not provide bail-outs in the case of firm failure. Among these four, one banking RSA in a jurisdiction mentions that private and government-owned banks are subject to a specific regime of recovery and resolution that provides bail-in, rather than bail-out, arrangements for recovery and resolution. Two banking RSAs in two jurisdictions can provide liquidity to government-owned banks by extending emergency loans as an LOLR facility. The other five RSAs that responded to the relevant survey questions either have implicit government guarantee schemes, or such a commitment is not indicated in their legislation. In one jurisdiction, there is a reported bail-out precedent in which a central bank assisted one bank in its jurisdiction with a view to restoring confidence in the overall banking system. A total of seven RSAs reported that government bail-out options are a final option after all other recovery and restoration methods have been exhausted (Figure 4.1.3.1).

Figure 4.1.3.1 Appropriate Periods of the Recovery/Resolution Process Where a Government Bail-out Would be Used



4.1.4 Deposit Insurance Schemes in Jurisdictions

A total of 15 responding RSAs from 13 jurisdictions provided explanations regarding the nature of their insurance providers/schemes. Deposit insurance providers in three jurisdictions are structured as part of the relevant RSAs for both conventional and IIFS participants, while the remaining jurisdictions reported having a separate entity, other than their relevant RSA, for the administration of their deposit insurance schemes. For instance, a deposit protection corporation, a subsidiary of one central bank, was established under a recently announced Act in the jurisdiction. Similarly, one jurisdiction established a deposit guarantee fund as a public entity under a resolution committee. The public entity acts as a “pay box plus”, and is mainly responsible for protecting depositors for conventional banks, including Islamic banks.

One RSA that is the responsible authority for all three sectors mentioned that the jurisdiction already has a statutory body on deposit protection, set up in 2010, aimed at protecting depositors in the bank and finance companies against the loss of their deposit in the unlikely event of a failure. One RSA in the banking sector mentioned that it has a deposit insurance scheme, but that it only covers conventional deposit liabilities, and there are no guidelines to

cover investment accounts under Islamic banking contracts. One RSA in the banking sector currently has no deposit insurance scheme in force, but a deposit insurance bill was prepared by the central bank. After public consultation, the bill was submitted recently to the ministry.

4.2 Current Recovery and Resolution Framework

4.2.1 Act/Regulation/Supervisory Guidelines/Supervisory Circulars/Statements

RSAs in all responding jurisdictions reported that they have guidelines contained in their Act/regulation/supervisory guidelines/supervisory circulars/statements that cover, to some extent, issues arising in the recovery and resolution process. The extent of coverage of these issues varies significantly from one jurisdiction to another. In the case of IIFS, since their underlying financial practices are based on some unique guidelines specific to Islamic Sharī'ah, the applicability of conventional guidelines needs to be checked carefully.

Most of the RSAs responding to the survey have regulatory powers in the areas of conservatorship, restructuring, moratorium, amalgamation, merger, liquidation, etc. to protect the assets of a financial institution for the benefit of its depositors and other creditors. One RSA in the capital market in one jurisdiction administers a separate compensation centre for the purpose of investment compensation if investment firms are unable to fulfil their obligations regarding cash payment within a short period of time after such payments are due. The capital market RSA takes the opinion of its banking sector counterpart (banking RSA) in order to make the compensation decision about financial institutions in the financial sector. In general, the compensation centre is obliged to make necessary preparations to compensate the investors within three months after determining the rights holders and compensation amounts. However, the provision of the law pertaining to the compensation centre does not apply to cash payment obligations, which are considered to be risk participation funds (in Islamic financial institutions), because of its unique contractual agreements.

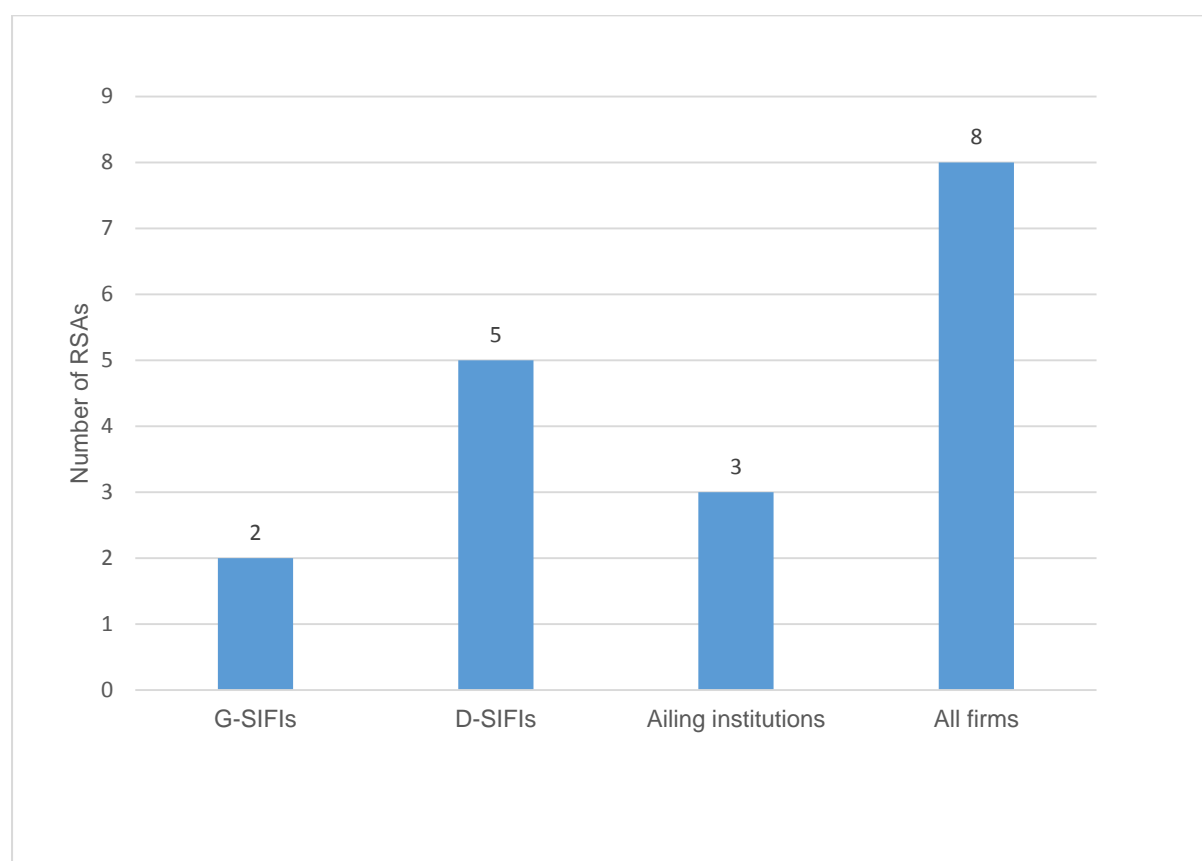
In one jurisdiction, an ordinance for financial institutions was issued in 2016 and is expected to become operative in 2017. The ordinance empowers a resolution authority to undertake recovery and resolution planning in respect of entities within the scope of the cross-sector resolution regime in that jurisdiction. There are also existing supervisory intervention powers in its banking ordinance that can be used, and have been used in the past, to deal with distressed ailing institutions. However, the banking sector RSA in that jurisdiction mentioned in its survey response that these supervisory intervention powers do not provide the full set of powers considered necessary to recover and resolve systemically important financial institutions as set out in the FSB's Key Attributes. One RSA that acts as the responsible authority for all three sectors has already planned to put in place a high-level recovery and

resolution blueprint. Banks will be required to submit their recovery and resolution plans as part of the high-level framework.

4.2.2 Own Recovery and Resolution Plan for Financial Institutions

A total of 13 RSAs indicated in their survey responses that their financial institutions (including IIFS) are required to create their own recovery and resolution plans, or similar plans for crisis situations, and to submit their RRP to their relevant RSA. Eight of these RSAs prefer to require RRP for all financial institutions (including IIFS), instead of limiting the requirement to only systemically important financial institutions or ailing institutions (see Figure 4.2.2.1).

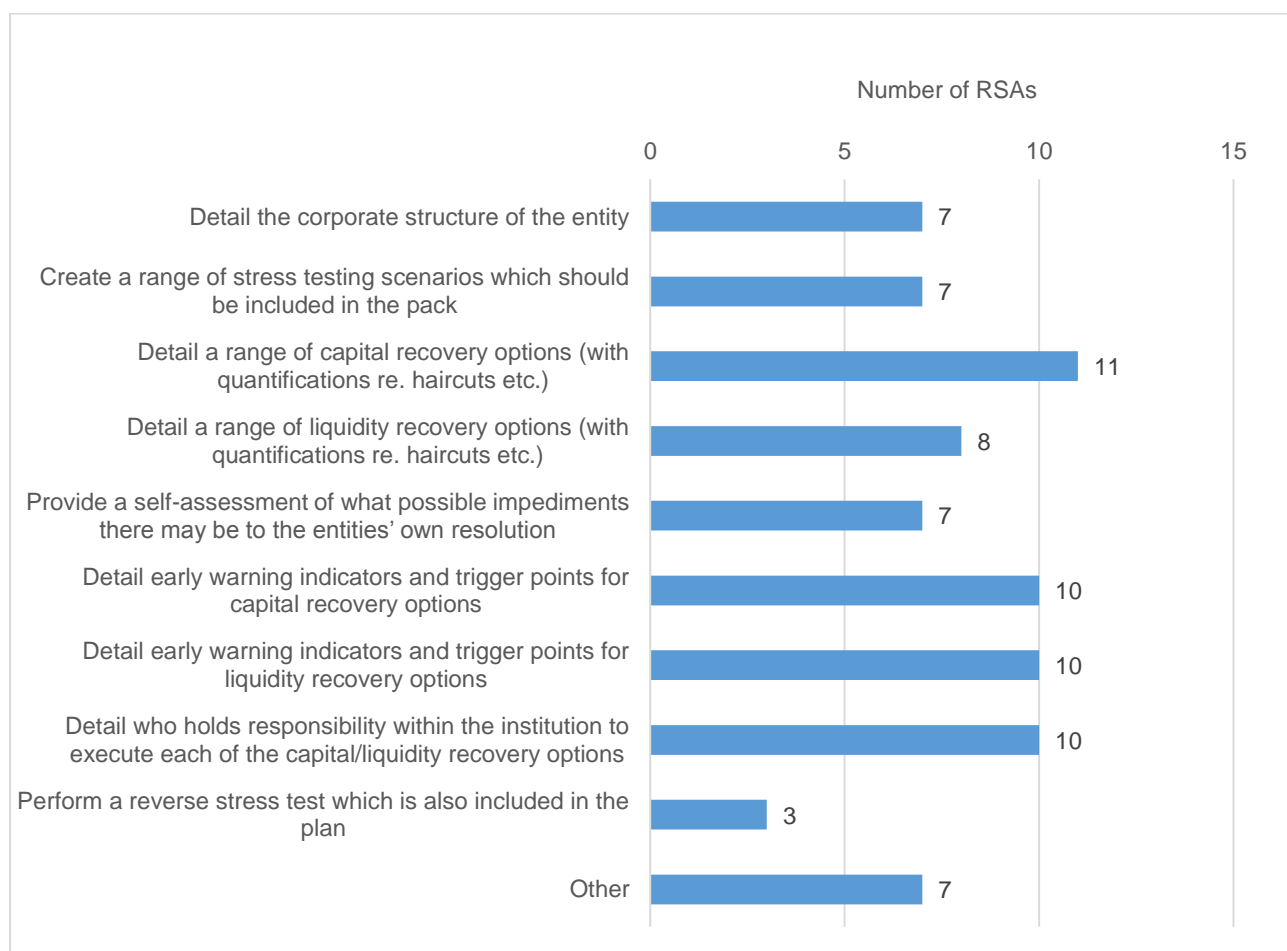
Figure 4.2.2.1 Types of Financial Institutions (Conventional and IIFS) Required to Create RRP



4.2.3 Appropriate Triggers in a Recovery and Resolution Plan

The RSAs were asked to identify the required indicators or framework elements for creating an RRP in their respective jurisdictions. Providing a detailed range of capital recovery options with quantifications of regulatory haircuts was cited as the most important indicator by most RSAs (11). Ten RSAs recommended that the financial institutions (including IIFS) require detailed early warning indicators and trigger points for capital and liquidity recovery options, and a detailed description of who holds responsibility within the institution to execute each of the capital and liquidity recovery options. Another important indicator, cited by eight RSAs, is providing a detailed range of liquidity recovery options (with quantifications of regulatory haircuts). Moreover, financial institutions are required to provide a detailed corporate structure relating to the entity, create a range of stress-testing scenarios, and provide a self-assessment of what possible impediments there may be to the entity's own recovery and/or resolution (Figure 4.2.3.1).

Figure 4.2.3.1 Potential Indicators Required to Create RRP or Similar Plans for Financial Institutions (including IIFS)



4.2.4 Current Status in Terms of Appropriate Triggers in RRP

The respondent RSAs expect that firms under supervision are required to maintain and update recovery plans that outline credible recovery actions for implementation in the event of severe stress (Figure 4.2.3.1). Their published statement on prudential regulations mentions that the appropriate triggers and procedures in a recovery plan can comprise a combination of quantitative and qualitative indicators, need to be timely (i.e. forward looking to provide adequate notice to take timely corrective action), be capable of being monitored, and establish arrangements to ensure that it is clear when the relevant criteria are not being met. An appropriate number of triggers that can be based on internal early warning indicators should be monitored in line with the firm's complexity and business profile.

Under the framework for recovery and resolution plans in another jurisdiction (which are still being finalised by their RSA), all ailing institutions (AI) are required to provide some core information to the RSA. An overview of an AI's group structure is also required to be submitted in connection with recovery and resolution planning. Moreover, the AIs may be required to maintain some specific leverage based upon their existing stress-testing scenarios as appropriate, provided that existing stress testing satisfies the requirements in the context of recovery and resolution planning. The AI should have such planned recovery and resolution options that are both realistic and far reaching enough to deal with a wide range of problems that it may encounter during the recovery and resolution process. Under their recovery and resolution planning requirements, AIs are required to develop and maintain a trigger framework. The primary intention underlying early warning indicators and triggers is to initiate prompt and timely activation of recovery and resource mechanisms.

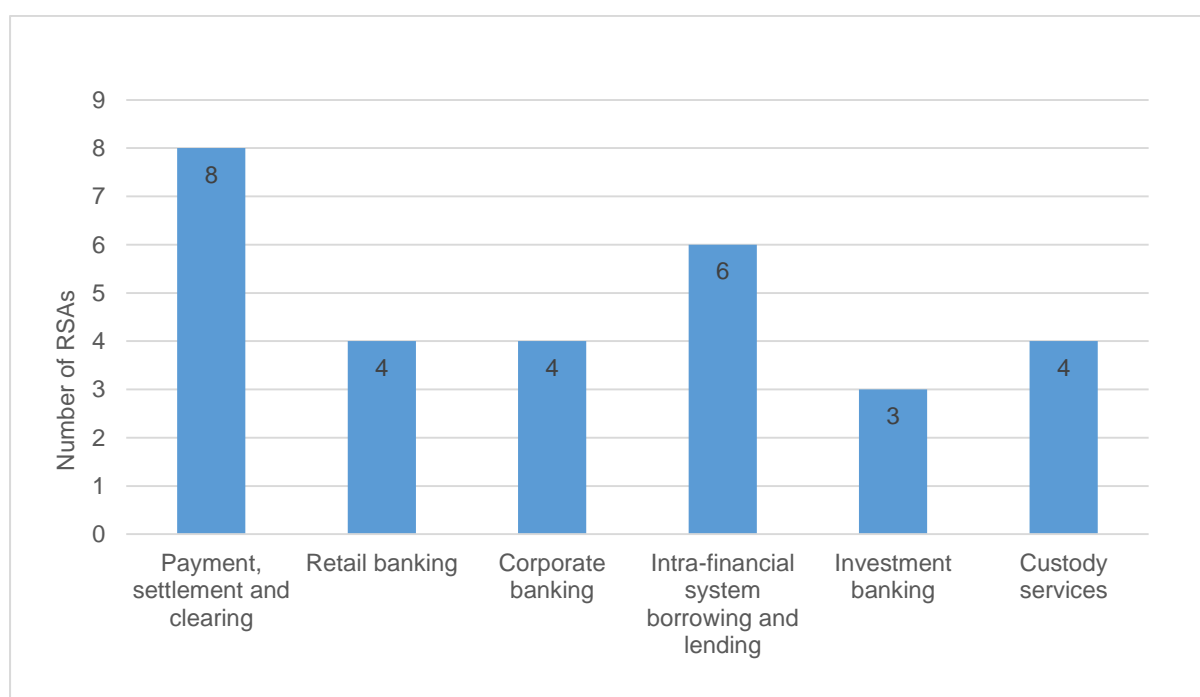
4.2.5 Regular Resolvability Assessment by the Responsible Authority

A total of 50% of the responding RSAs (eight) mentioned in their survey responses that financial institutions (both conventional and IIFS) are subject to regular resolvability assessments by the appropriate responsible authority. Regarding a future resolvability assessment framework, a total of 18 RSAs indicated that the resolvability assessment should be the same for IIFS as for conventional institutions.

4.2.6 Critical Economic Functions and Domestic Systemically Important Banks (D-SIBs)

“Critical economic functions” refers to the activities, services or operations carried out by a financial institution, the discontinuance of which is likely to lead to the disruption of services that are essential to the real economy or which may lead to disruption of financial stability in the jurisdiction. This may be due to the size, market share, external and internal interconnectedness, complexity or cross-border nature of the activity, service or operation. The survey responses indicate that payment, settlement and clearing (indicated by eight RSAs), and intra-financial system borrowing and lending (indicated by six RSAs), are the two most important critical economic functions. Other important critical economic functions are retail banking, corporate banking and customer services, as indicated by four RSAs (Figure 4.2.6.1).

Figure 4.2.6.1 Critical Economic Functions in Jurisdictions



The RSAs in seven jurisdictions have guidelines for identifying the D-SIBs in their respective jurisdictions. To date, no IIFS has been classified as a D-SIB in these countries. In addition, two central banks are in the process of introducing regulatory guidelines to define criteria and specific requirements for D-SIB categorisation. Though no IIFS has yet been designated a D-SIB in the jurisdictions under survey, a total of 12 jurisdictions where Islamic finance has

achieved systematic importance need to address either separate regulation or application of conventional regulation framework for recovery and resolution of IIFS.⁸⁹

4.2.7 Sharī'ah-compliant Lender-of-last-resort Facilities

Only three responding banking RSAs have Sharī'ah-compliant LOLR facilities for their Islamic banks. One RSA mentioned that there are no Sharī'ah-compliant LOLR facilities in the jurisdiction, but its proposed amendment to the charter includes a provision to address this deficiency.

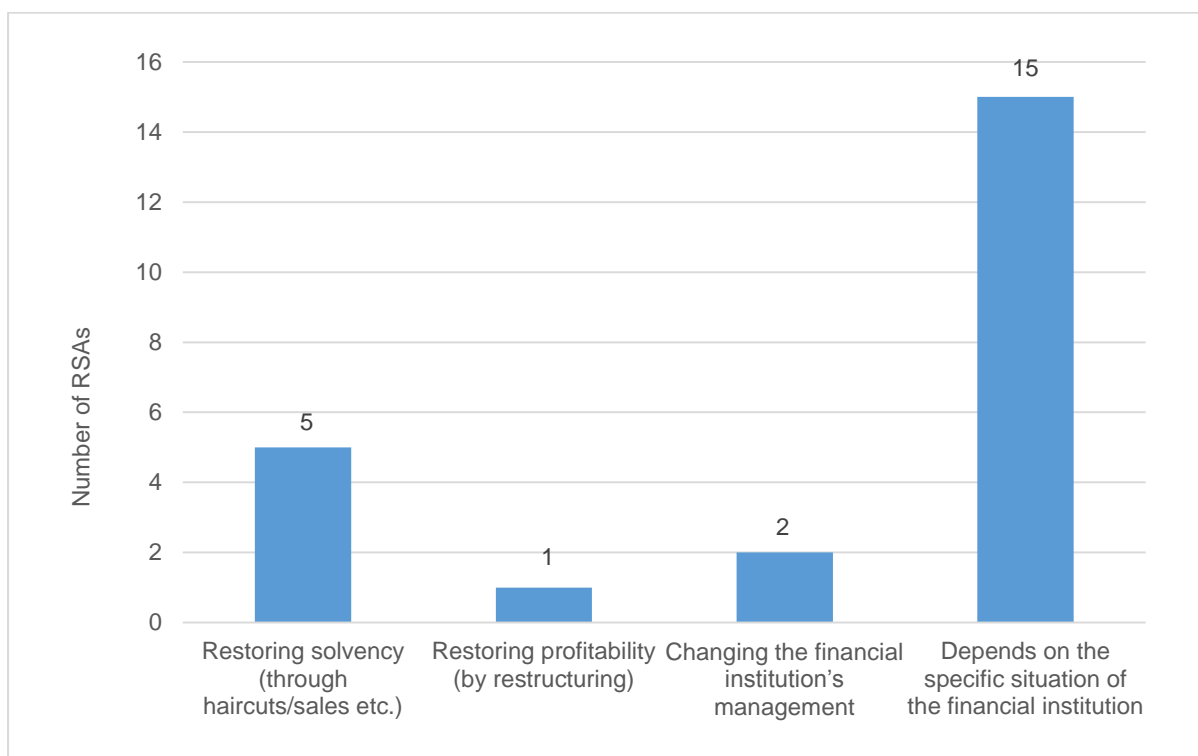
4.3 Powers of the Resolution Authority

4.3.1 Powers of the Resolution Authority during Stress

If a financial institution encounters stress and the resolution authority is required or authorised to step in, most RSAs (15) take measures that are related to the specific situation of the stressed financial institution. Restoring solvency through haircuts and asset sales could be applied, as mentioned by several RSAs (five). Only a few RSAs (two) indicated that they prefer to change the management of the financial institution to ensure cost efficiency and to maintain confidence and stability in the financial system (Figure 4.3.1.1).

⁸⁹ The IFSB's *IFSI Stability Report 2017* considers the Islamic financial sector as being systemically important when total Islamic banking assets in a country comprise more than 15% of its total domestic banking sector assets. The report identified a total of 12 jurisdictions where Islamic finance achieved domestic systemic importance. The countries are Iran, Sudan, Brunei, Saudi Arabia, Kuwait, Yemen, Qatar, Malaysia, UAE, Bangladesh, Djibouti and Jordan.

Figure 4.3.1.1 Powers of Resolution Authority if a Financial Institution Encounters Stress



A total of 18 jurisdictions mentioned in their survey responses that they will remove or replace senior management and appoint an administrator, receiver or other authority to take control of the firm if the firm encounters stress. The RSAs' preferences in regard to the possible options are shown in Table 4.3.1.1.

Table 4.3.1.1 Powers of Resolution Authority

	Power	Mentioned by Number of RSAs
1	To remove/replace senior management	18
2	To appoint an administrator, receiver or other authority to take control of the firm	18
3	To transfer/sell assets and/or liabilities, legal rights and obligations to a solvent third party	15
4	To effect the closure and orderly wind-down of the whole or part of a failing firm	14
5	To override the rights of shareholders of the firm	13
6	To operate and resolve a firm (including terminating/assigning contracts and writing down debt)	12
7	To temporarily stay the exercise of early termination rights that may be otherwise triggered	11

	Power	Mentioned by Number of RSAs
8	To impose a moratorium with a suspension of payments to unsecured creditors and customers	11
9	To establish a temporary bridge institution to undertake sale/transfer of assets to another institution	10
10	To carry out mandatory bail-ins within resolution (on bondholders and/or <i>ṣukūk</i> holders)	9
11	To require other companies in the group to continue to provide essential services to the entity being resolved	7

The law of the jurisdiction in one respondent RSA establishes the bases for application of procedures of preservation or voluntary and involuntary liquidation (including the process of bankruptcy) applicable to banks in that jurisdiction. Under this law, the relevant RSA assesses the conditions of their application, and also other relations resulting from inability or refusal of the bank to meet requirements of creditors or violation of requirements of the legislation. The relevant RSA has a recovery and resolution framework for those banks that are likely to fail and for banks that may terminate banking activities pursuant to a decision of the bank's shareholders.

One banking RSA mentions that if it revokes the operating permission of a failing bank, the management and control of the bank are transferred to a separate entity for savings and deposit insurance of the concerned bank. The separate entity as a resolution authority thereafter exercises its resolution powers regarding the failed bank pursuant to banking law in the jurisdiction. The entity also pays against insured deposits and insured participation funds, and subsequently executes the bankruptcy of the failed bank. The resolution authority is also empowered to transfer the assets, organisation, staff, insured deposits and participation funds of the bank to another bank or to merge it with another bank. The resolution authority can restructure, rehabilitate and strengthen the financial structure of the bank through increasing capital, purchasing real estate, subsidiaries or assets, or injecting a deposit, provided that the resolution authority owns all or a majority of the shares of the bank.

One RSA (central bank) in another jurisdiction indicated that, as per the relevant banking Act, the board of directors of the central bank may appoint a receiver for a failing bank, and the receiver's duties are comprised of: (a) commencing proceedings leading to compulsory liquidation of the assets of the financial institution; (b) taking such measures as it thinks fit in respect of a financial institution of which it has taken possession within a period of not more than 30 days from the date of taking possession; or (c) terminating the taking of possession.

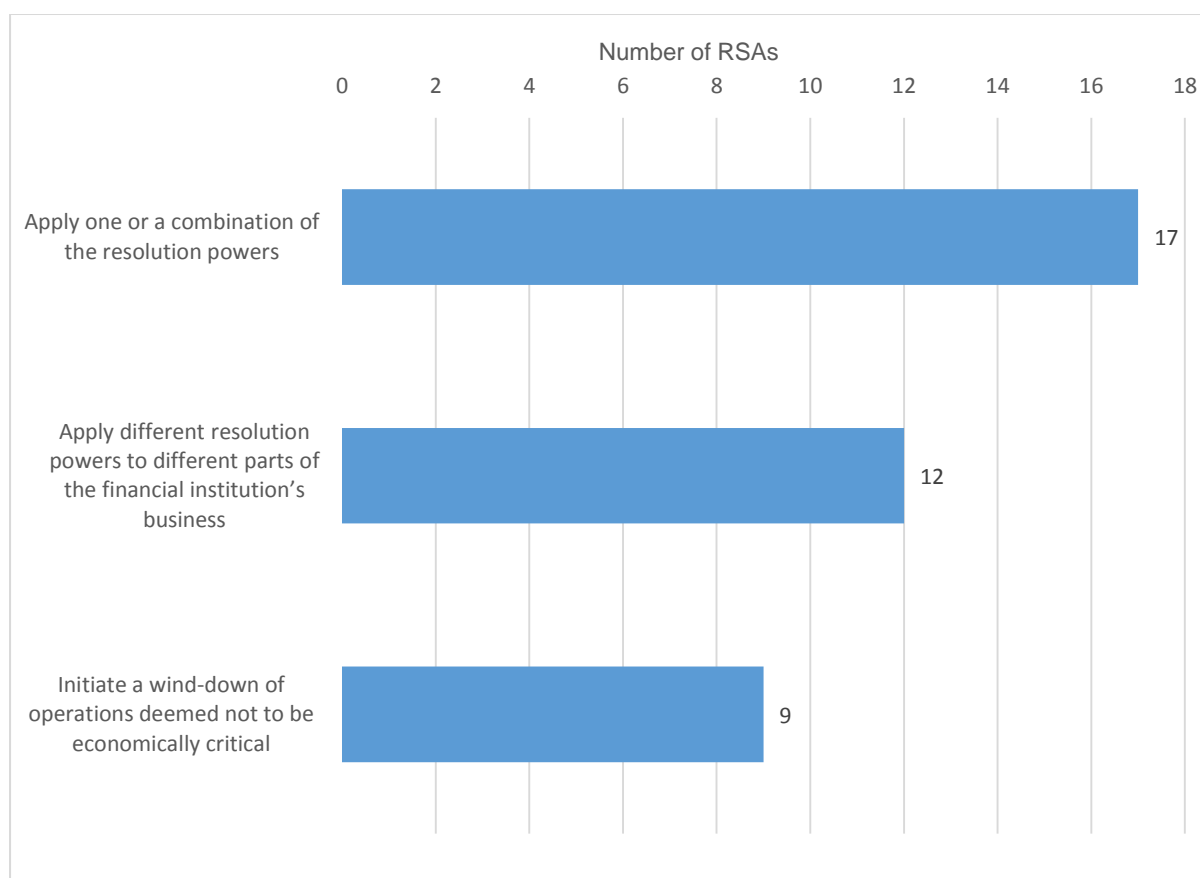
In one jurisdiction, the deposit insurance entity has the resolution power of its member institutions only. The entity also applies its power to identify Sharī'ah-related considerations in the operation of IIFS. The entity exercises the resolution powers upon receipt of a notice of non-viability from the banking RSA in that jurisdiction. The triggers for determining whether the entity's member institutions are failing, or likely to fail, are under the purview of the banking RSA. The entity can also carry out mandatory bail-ins within resolution on the bondholder and/or *ṣukūk* holders.

One central bank in another jurisdiction mentioned that it has powers to change bank management, impose restrictions on advances and other business activities and capital expenditures of a bank, suspend refinance facilities, or extend the repayment period of refinance facilities, if any bank is failing or likely to fail. Another jurisdiction is also in the process of introducing an amendment to its banking law that will allow its central bank to create a bridge bank.

Although there is not an explicit power to appoint an “administrator” or “receiver” under the ordinance in one jurisdiction, a resolution authority is empowered to take control of a financial institution in recovery or resolution and may appoint a person to perform this role for the recovery and resolution authority. Currently, while the ordinance is not yet in operation, the relevant RSA has some of the recovery and resolution powers (including the ability to appoint a manager to manage the affairs, business and property of an ailing institution).

Most of the responding RSAs (17) apply a combination of recovery and resolution powers if any financial institution encounters stress, as indicated in Figure 4.3.1.2.

Figure 4.3.1.2 Legal and Operational Capacities of the Resolution Authority



4.3.2 Potential Triggers Used by Resolution Authority for a Financial Institution that is Failing or Likely to Fail

Although most jurisdictions have not yet established a formal framework for determining whether a financial institution is failing or likely to fail, most RSAs respond that a set of potential triggers should be required and available to trigger the involvement of the competent recovery and resolution authorities.

A total of 15 responding RSAs indicated that potential triggers should be available when an institution infringes, or is likely in the near future to infringe, the capital requirements set by the RSA (e.g. the CAR ratio). A total of 12 RSAs mentioned that an institution shall be deemed to be failing or likely to fail if objective determinations support the conclusion that the total assets of the institution will, in the future, be less than its liabilities. In this regard, the central bank in one jurisdiction has a guideline indicating that a bank is a failing bank based upon criteria indicating that bank losses exceed 75% of its subscribed capital. Nine responding RSAs indicated that recovery and resolution tools should also be applied by the competent authority

where the institution cannot be wound up under normal insolvency proceedings without destabilising the financial system or having an adverse impact on the wider economy.

Significant adverse developments in the financial system could threaten the capital position and viability of individual banks, including relevant developments in interest rates, real estate values or economic growth. Such developments significantly affect the business model of the institution, and its profitability, capital position and viability. A total of seven responding RSAs indicated that a significant deterioration in the market perception of an institution could threaten its insolvency. The market perception of an institution reflected by signs of non-temporary deterioration in the absolute and relative evolution of market indicators – for example, equity-based indicators or debt-based indicators – suggests that solvency of the institution is severely impaired and its capital position and viability would be threatened (Table 4.3.2.1).

Table 4.3.2.1 Potential Triggers on Capital Used by a Resolution Authority to Determine a Financial Institution that is Failing or Likely to Fail

	Capital Indicators	Responding RSAs
1	Infringe on capital requirements set by the RSA (i.e. CAR ratio)	15
2	Have assets that are less than its liabilities	12
3	Significant adverse developments in the wider economy that threaten the institution's capital position and viability	9
4	Indications of a significant decrease in the value of assets following an asset quality review	7
5	Significant deterioration of the institution's market perception, which could threaten its solvency	7
6	Following any type of institution-specific assessment on the value of its assets/liabilities	6
7	Likely materialisation of the institution's significant off-balance sheet items	4
8	Significant non-temporary increases in the institution's cost of funding	3

A total of 12 RSAs also mentioned in their survey responses that an institution should be considered as failing or likely to fail if there are objective elements to support a determination that in the near future it will infringe regulatory liquidity requirements, or it will be unable to pay its debts and liabilities. Moreover, significant adverse developments in the macroeconomic environment could threaten an institution's liquidity position and the sustainability of its funding profile, and its compliance with the minimum requirement for liquidity, as indicated by six responding RSAs (Table 4.3.2.2).

**Table 4.3.2.2 Potential Triggers on Liquidity Used by a Resolution Authority
for a Financial Institution that is Failing or Likely to Fail**

	Liquidity Indicators	Responding RSAs
1	Infringe on liquidity requirements set by the RSA (i.e. high-quality liquid assets buffer)	12
2	Be unable to pay debts and liabilities as they fall due	12
3	Significant adverse developments in the wider economy that threaten the institution's liquidity position and viability	6
4	Loss/termination of any significant liquidity lines from the wider market	5
5	Significant ratings downgrades/deterioration in market perception that would significantly increase cost of funding	4
6	Access to long-term funding is significantly reduced or becomes much higher in cost	3
7	Non-temporary increase in the institution's cost of funding	2

4.3.3 Power of Authority to Other Jurisdictions

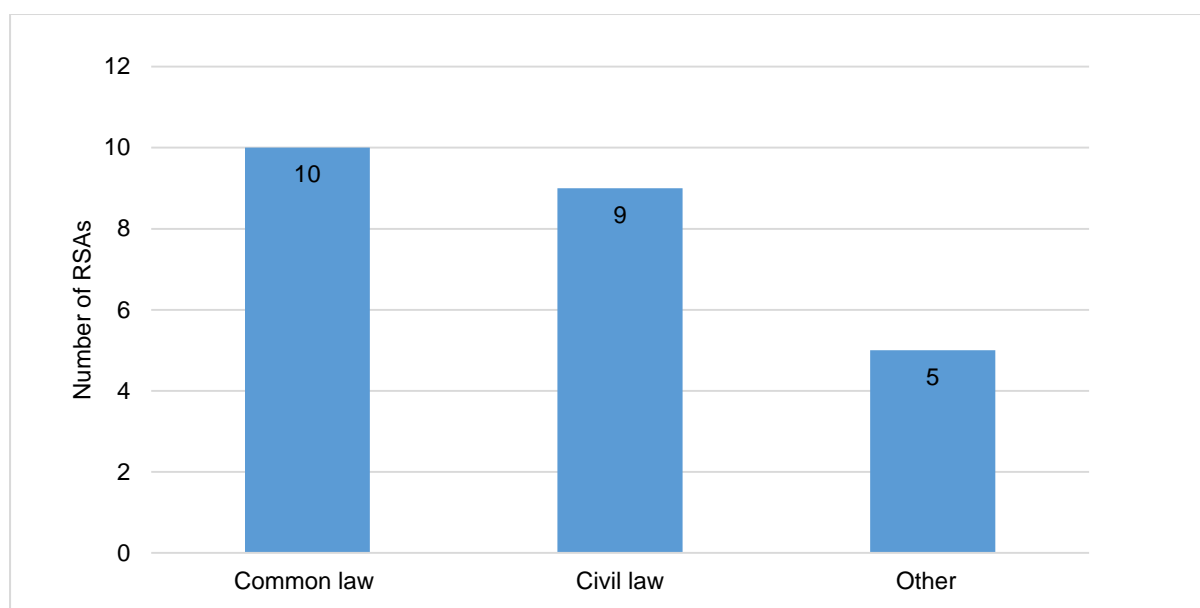
A total of 74% of the responding RSAs (14), from 12 jurisdictions, mention that they can enter into agreements with the resolution authorities of other jurisdictions if needed. It is usually required that the agreements with other RSAs must comply with the requirements of the requesting jurisdiction.

4.4 Legal Framework

4.4.1 Common and Civil Law

Jurisdictions of responding RSAs include both common law and civil law. A total of 10 RSAs are in common law jurisdictions, and nine RSAs are from civil law jurisdictions. Some jurisdictions apply both common and civil laws in the resolution of their financial institutions (Figure 4.4.1.1).

Figure 4.4.1.1 Type of Legal Framework in Jurisdictions



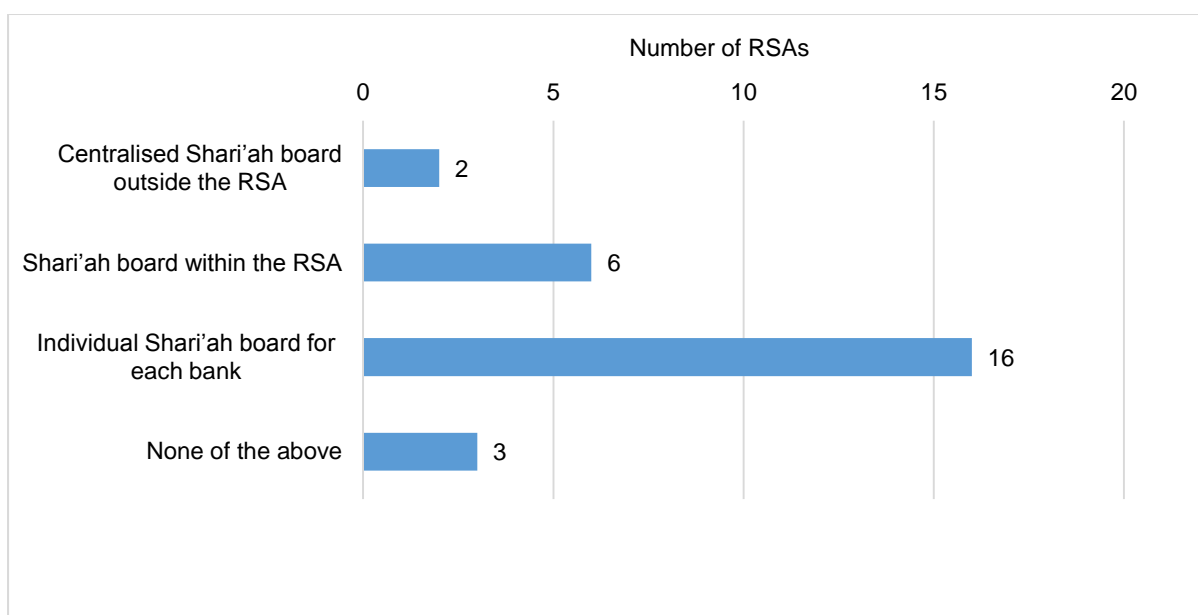
4.4.2 Legal Framework for Voluntary Bankruptcy or Voluntary Insolvency

A total of 47% of the responding RSAs (seven) allow their financial institutions (both conventional and IIFS) to declare voluntary bankruptcy or voluntary insolvency in their jurisdictions subject to approval from the relevant resolution authority. Only one jurisdiction has a legal framework that incorporates specific statutes for dealing with Islamic finance bankruptcy and insolvency. Certain provisions in the deposit insurance Act address the order of payments in the winding-up of a deposit-taking member (including Islamic deposit-taking members) and of an insurer member (including *takāful* operators).

4.4.3 Sharī'ah Board

Only two RSAs mentioned that centralised Sharī'ah boards exist outside of those RSAs. Six RSAs have their own Sharī'ah board within the RSA. A total of 16 RSAs replied that they have individual Sharī'ah boards for each bank in their jurisdiction. Out of these 17 RSAs, seven mentioned that they also have centralised Sharī'ah boards within or outside the RSA. A total of three responding RSAs indicated that there are no Sharī'ah boards of any type in their jurisdiction (Figure 4.4.3.1).

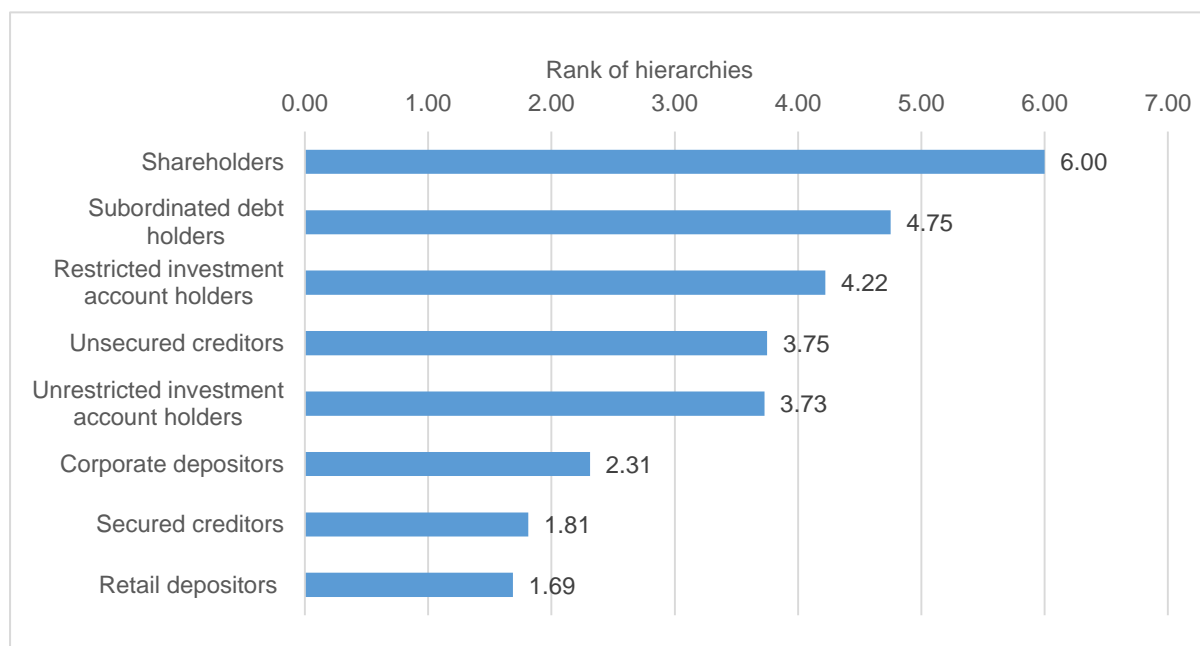
Figure 4.4.3.1 Models of Shari'ah Boards in Place in Jurisdictions



4.4.4 Rank of Hierarchies on the Claims of Creditors/Depositors

The survey attempted to determine how different jurisdictions rank the claims of different types of creditors, depositors and investors relative to one another. The RSAs were asked to indicate the ranking of hierarchies on the claims of creditors/depositors from 1 to 8, with 1 being the most protected. The results calculated are based on the average of aggregated ranking responded against each category of creditors/depositors. Figure 4.4.4.1 shows that shareholders will bear the loss at first (rank calculated at 6.00 out of 8.00). Typically, the shareholder's equity should absorb the losses first, followed by subordinated debt holders (rank calculated at 4.75). Restricted investment account holders, which are unique to Islamic banking contracts, also need to bear losses in order (4.22) followed by unsecured creditors (3.75) and unrestricted investment account holders (3.73).

Figure 4.4.4.1 Rank of Hierarchies of the Creditors (Ranked from 1 to 8, with 1 Being the Most Protected)



CHAPTER 5: ISSUES IN RECOVERY, RESTRUCTURING AND INSOLVENCY

5.1 Overview

As stated in the opening chapter of this working paper, the IFSI is not immune from distress and failure. There have been a number of well-publicised defaults and insolvencies over the past few decades, involving both Islamic financial institutions and specific *ṣukūk* structures.

The current economic conditions in a number of the key markets where the IFSI is developed and prevalent are challenging. In the Middle East and North Africa region (especially the Gulf Cooperation Council) and parts of Asia-Pacific (i.e. Malaysia), reduced oil prices and geopolitical conflicts can have a significant impact on the wider economy. Given that Islamic banks are providing finance solutions and services (as well as making investments) in local and regional markets, financial distress and fluctuating markets are a reality for them. If not managed adequately, or if impediments remain with regards to the tools and powers available to an authority that has to deal with such scenarios, defaults and insolvencies can become a real risk.

The literature review carried out in Chapters 2 and 3 of this paper conceptualises the recovery and resolution framework from a best-practice perspective in terms both of global standard setters and of actual jurisdictions. It then applies and considers this framework in the context of the Islamic finance model, highlighting key issues and Sharī'ah requirements.

Following a case study on an actual instance of insolvency and bankruptcy in Islamic finance involving Turkey's Ihlas Finans House, the paper examines some of the causes of, and issues arising from, the relevant events and how the responsible authorities dealt with the process. Other good sources of information on recovery processes, including reorganisations and restructurings, in the bankruptcy context are the well-publicised cases of Arcapita and the East Cameron Gas *ṣukūk*. There have also been other *ṣukūk* defaults and restructurings, some of them still in process at the time of scrutiny. The aim of this analysis is to highlight key lessons that can be learned from such events. Issues that involve Sharī'ah principles, and certain conflicts and difficulties that have arisen when dealing with the recovery and restructuring, are noted.

5.2 Ihlas Finans House (Turkey)

5.2.1 Background

The Ihlas Finans House (IFH) case study pre-dates modern thinking on recovery and resolution, given that it took place in the 2000s. Turkey has made major advances over the last two decades in enhancing its legal and regulatory framework for IIFS. This case study offers insights and lessons for jurisdictions that have not yet developed their frameworks, and should be read in this context.

The special finance house (SFH) subsector, established under decree no. 83/7506 of the Turkish government (1983), allows entities to collect funds for investment purposes on an interest-free, profit- and loss-sharing basis.⁹⁰ IFH was an SFH and the subsidiary of a diversified parent (Ihlas Holdings), which had various interests across media, health care and construction. By the year 2000, IFH had grown to become Turkey's largest SFH, with around 40% market share.

SFHs competed with Turkey's conventional banking sector for deposits. However, an important difference between the conventional and SFH sectors (including IFH) was that SFHs were not covered by the Turkish deposit insurance scheme at that time. IFH's business strategy was focused on providing financing to the small and medium enterprise (SME) sector, largely through short-term *murābahah* financing arrangements. It also offered *ijārah* services and some *muḍārabah* and *mushārahah* asset-side partnerships for SMEs that wanted longer-term project financing. Liabilities were almost exclusively comprised of participation (investment) accounts with a small number of current accounts. IFH had a profit-sharing ratio of 80–20 as between its investment account holders and itself.

5.2.2 Macroeconomic Context

Following a liquidity crisis due to a bank run (the result of a wider banking crisis in 4Q00), IFH was shut down in 2001 by the Turkish Banking Regulation and Supervision Agency (BRSA) and liquidated according to the provisions of the Turkish Commercial Law. To understand what caused the entity to fail, the wider economic and banking sector context should be highlighted.

Economically, Turkey experienced high inflation and a large public burden which became apparent by the turn of the millennium. GDP had shrunk.⁹¹ The banking sector itself also

⁹⁰ Islamic risk-sharing contracts such as *muḍārabah* and *mushārahah* would come under this definition.

⁹¹ Banking Regulation and Supervision Agency Working Paper (Revised Third Edition) (2010). *From Crisis to Financial Stability (Turkey Experience)*.

suffered as a result of the wider economic issues. This was highlighted by the accumulation of debt burden and moral hazard issues, which resulted in lax risk management.

5.2.3 Turkish Banking Sector Failure

The Turkish banking sector had accumulated a large exposure to the public sector and the Turkish government, due to state-level influence and the government's debt rollover requirements. Induced, at least in part, by the poor health of the Turkish economy, banks whose management and control were transferred to the Savings Deposit Insurance Fund (SDIF) were liquidated or resolved in this period. The crisis was exacerbated by criminal investigations into a number of banks, which resulted in capital flight and asset sell-offs.⁹² IFH itself faced a bank run by IAH seeking cash withdrawals. Despite a vast majority of IFH liabilities being due only at maturity of the investments (since the accounts were investment accounts), management decided to allow early withdrawals of amounts invested in not-yet-matured investments. IFH simply could not keep up with the liquidity outflow. At the same time, assets were quite illiquid due to IFH's heavy exposure in the SME sector. The BRSA stepped in and determined that a number of management and governance failures had occurred. IFH's licence was revoked and the entity was placed into liquidation as a result.

5.2.4 IFH Prudential Indicators

A detailed analysis of IFH's balance sheet and key prudential indicators has been carried out by the Islamic Development Bank's Islamic Research and Training Institute.⁹³ An overview is provided in Table 5.2.4.1.

⁹² According to *The Economist* (7 June 2007), the overnight interbank offer rate went up to 1950% ("Turkey and the IMF: Take Ten Billion", (December)).

⁹³ S. Syed Ali (2007). Financial Distress and Bank Failure: Lessons from Closure of Ihlas Finans in Turkey, *Islamic Economic Studies*, 14(1), August.

Table 5.2.4.1 IFH's Key Prudential Indicators (2001)

Risk Indicator	Amount	Comment
Capital adequacy ratio	5.39%	The CAR is far below the Basel-required level of 8%
Deposit composition	96% participation (invest) accounts	Liabilities consisted mostly of investment accounts, which had maturity terms
Liquidity ratio	4.22% (liquid assets to total assets)	Low in comparison to other SFHs, which were 10%. General liquidity issues for SFH as they could not invest in government securities
Duration gap	+0.432 years	Assets substantially longer than liabilities

The indicators in the table show that, from a prudential risk perspective, IFH's financial health was weak. The entity had low capital adequacy for loss absorption, illiquidity (ultimately, its downfall), and a substantial maturity mismatch. Coupled with poor management decisions (allowing early withdrawal on not-yet-matured liabilities) and a lack of support infrastructure (no deposit insurance scheme) for SFHs, IFH encountered a liquidity stress from which it did not recover. The actual revocation of its operating licence was attributed largely to management and governance failings uncovered by the BRSA. However, the financial risk indicators alone show an entity vulnerable to stress conditions and without any readily apparent recovery and resolution options.

5.2.5 Liquidation and Insolvency

Unlike conventional Turkish banks, whose liquidation processes were carried out by the SDIF when their operating licences were revoked by the BRSA, IFH had its licence cancelled by the BRSA and, as a result, was placed into liquidation under the standard provisions of the Turkish Commercial Code (like any other corporation). The BRSA was not a participant in the subsequent liquidation process, which was overseen by a liquidation board. Subsequent to

the IFH liquidation, changes have been made in Turkey and IIFS would now have their liquidations overseen under the banking law by the SDIF.⁹⁴

A press statement⁹⁵ made by IFH shortly after it was put into liquidation outlines the creditor hierarchy for liquidation, which is said to be in accordance with Turkish law. The hierarchy is as follows:

- (a) debts owed to government (tax and similar obligations);
- (b) personnel debt (severance and other similar obligations);
- (c) current account holders;
- (d) profit- and loss-sharing account holders;
- (e) other debts; and
- (f) shareholders' receivables.

The risk-sharing accounts were subordinated to the current accounts, but ranked senior in liquidation to other debts owed by the bank. A 2008 report by the liquidation board⁹⁶ states that IFH had paid back all debt owed to the government and current account holders. It had also significantly reduced the amount of participation accounts held by repaying IAH on a monthly basis. It is not clear how it was decided which IAH to pay out first, given that this was an ongoing process. From a purely Sharī'ah perspective, the risk-sharing accounts should be considered a class of their own. As for the ranking of profit-and-loss sharing account holders with different maturities, they should be treated equally, since the fact of having different maturities does not impact on the ranking of the risk-sharing accounts. In short, all the risk-sharing accounts, regardless of their maturities, should be treated *pari passu* in terms of the payment priority.

The hierarchy that was followed in the IFH liquidation is a good example of a local legal framework using its own tenets and principles in effecting a liquidation. The liquidation board report is generally mute on issues of Sharī'ah compliance (which also reflects the socio-political environment in which IFH operated). The private independent audit report⁹⁷ of IFH, the entity in liquidation (also from 2008), showed the participation accounts as "Savings Deposits" in the balance sheet. The participation accounts were treated conterminously with

⁹⁴ EFG Istanbul Securities, Equity Research Turkey – Ihlas Holding (November 2005): the deposit insurance provider leading on bank resolution/liquidations is a general trend that can be observed globally. The resolution powers are being centered into the deposit insurance providers who deal with deposit pay-outs already. There is operational synergy between what these entities currently do and what is required from a resolution authority.

⁹⁵ Press Statement by the Liquidation Board about the Extraordinary General Assembly Meeting of Ihlas Finans in Liquidation (4 August 2001).

⁹⁶ Ihlas Finans in Liquidation – *Report of the Liquidation Board* (2008).

⁹⁷ Ihlas Finans Kurumu Anonim Sikreti in Liquidation (*Private Independent Audit Report* – 2008).

normal savings accounts and therefore were paid out in the same manner. Other debtors, as the ranking indicates, were subordinated.

This case study illustrates a general policy that jurisdictions may wish to adopt with regards to IAH. As mentioned in Chapter 3, a vast majority of IAH are retail customers who are looking for a Sharī'ah-compliant alternative to conventional savings accounts. As such, most regulatory frameworks would want to protect such customers equally as well as they protect conventional savings account holders. So, while Sharī'ah principles would dictate that such depositors are risk sharers who could, in theory, bear all losses on their accounts without recourse to the bank, treating them in the conventional manner with respect to creditor hierarchies could be a better way of dealing with them should an IIFS collapse. This may be accomplished through the use of explicit legal clauses which articulate Sharī'ah principles first and then explain deviations from those principles, or by allowing the general legal framework to run its course. Clearly, this is a policy determination that should be made in consultation with the relevant Sharī'ah scholars.

The available information regarding repayments to IAHs is incomplete and somewhat unclear. For example, it is unclear whether payments were made on the basis of initial funds deposited, deposited funds and accrued profit, or whether some other (probably lower) amount was calculated after a certain amount of losses were factored into the calculations. Each one of these payout quantifications is also an area that policymakers and RSAs may wish to consider further. Details on how assets were liquidated, and at what prices (e.g. whether debt was sold at discount), are also not clear from the available material. Nor does the available information indicate how IFH's share of investment assets (if any) was carved out from investment assets, or how asset availability determinations were made. It is likely, given the general liquidation process, that conventional insolvency practices were applied throughout the process.

While SFHs were brought under the Banking Law in 1999, in 2005 the SDIF started to cover deposits of participation banks (i.e. participation funds), and to become responsible for carrying out resolution and liquidation processes of participation banks. The same procedures for conventional banks are now followed for participation banks in accordance with the Banking Law. However, there is a difference in deposit payouts as between conventional banks and participation banks. If the operating licence of any participation bank is revoked, payments to participation account holders are made based on the unit account value. On the other hand, if a conventional bank's operating licence is revoked, the amount payable under the insurance is determined based on the principal and interest amount. Since there is no separate Sharī'ah-compliant deposit insurance scheme, Sharī'ah principles are not considered in shaping resolution and liquidation processes of participation banks. In 2015,

when a participation bank, Bank Asya, failed in Turkey, the failure was taken care of by the SDIF according to Articles 106 and 107 of the Banking Law. The same procedures have been followed for Bank Asya as were followed for other conventional banks that had failed in the past.

It is also interesting to note that, under the general liquidation procedure that was applied to IFH, the IFH itself chose a liquidation board. It did not place any Sharī'ah experts on the liquidation board despite the obvious benefits that might have been obtained by having such experts assist in analysing and guiding the process with regards to the relevant Islamic principles underpinning the contracts. The degree of tolerance of the Turkish legal system with involvements of Sharī'ah scholars in the liquidation process is also unclear.

5.2.6 Key Take Aways

First, it is clear that IFH, along with its banking peers (whether Islamic or conventional), did not have a clear idea of what recovery and resolution options it could execute in a stress scenario in an effort at recovery and continuing IFH's operation. The management's decision to allow liquidity withdrawals may have been based upon reputational risk considerations. That may or may not have been prudent. But the prudence of such a determination can only be accurately evaluated in a context that considers all the then-available recovery alternatives that might now be included in an RRP. No such RRP existed at IFH, and a complete analysis cannot be made. It is clear, however, that IFH management did not have a plan of action that could help them try to recover the firm's financial position amidst a bank run.

As discussed in Chapter 3 of this paper, recovery options can include (a) lender-of-last-resort facilities, and (b) intragroup support arrangements, among others. It does not seem that IFH had access to any such LOLR facilities from the Central Bank of the Republic of Turkey (CBRT), since IFH became insolvent in 2001 and SFHs were not banks at that time. Therefore, the CBRT could not assist IFH during its liquidity outflow crisis. Similarly, the ownership of IFH was such that part of the SFH was publicly owned (shares), but a majority shareholding came from its parent – Ihlas Holdings. In turn, Ihlas Holdings was 40% owned by one individual.⁹⁸ There did not seem to be any intragroup support forthcoming for IFH. Also, given the conglomerate nature of the holding company (which had interests in a number of different business sectors), it may not have been prepared or able to assist one of its subsidiaries in a banking crisis.

⁹⁸ *Ihlas Holdings Annual Report 2001.*

In terms of asset sales, IFH's financings were heavily focused on the SME sector. It would have been difficult to realise these assets in the middle of a stress event. The issues discussed in Chapter 3 with regards to selling these assets (which were largely *murābaḥah*-based debt assets) come to the fore in this case study. One example is that sales of these assets at a haircut may present significant Sharī'ah issues. Similarly, without any predefined assets that could be sold and without pre-targeted acquirers, the ability of the IFH management to quickly formulate a recovery strategy while dealing with a liquidity crisis was seriously hampered.

The investment accounts comprising the liabilities side of the IFH balance sheet had term maturities, and those terms extended significantly beyond the period of the IFH liquidity stress. A predefined RRP would likely have provided for identification of alternatives and details as to how those alternatives could be immediately implemented. It would also have provided for ongoing monitoring that would have allowed for immediate action. For example, that monitoring would have identified the extent of permissible withdrawals in the stress scenario. Without such a plan, uninformed decision making, possibly even panicked decision making, may have prevailed such that IFH senior decision makers allowed excessive withdrawals despite the potential shock absorber characteristics the Islamic contracts provided. This is a good example of how PSIAs may behave in a crisis and why detailed consideration of alternatives and their consequences is critical to the efficacy of the recovery and resolution process.

Perhaps one of the most important financial safety nets that was unavailable to IFH was a DIS. Having deposit insurance arrangements in place may have eased depositor worries and dampened the liquidity run, either completely or in terms of its intensity. The importance of the interaction between safety net mechanisms such as DIS and LOLR within the wider recovery and resolution context is also something RSAs and policymakers should consider carefully and analyse when developing their frameworks.

The IFH case outlines both the vulnerability of IIFS, as well as some of the structural issues they may face in terms of liquidity and recovery and resolution. The actual failure of the SFH is, however, multilayered with regards to causality; management and governance, macroeconomics, and lack of regulatory oversight all played a part. However, it serves as an illustrative case study with regards to how a well-defined recovery and resolution framework that has carefully considered recovery options as well as resolution planning could aid a firm in distress. For the reasons detailed in Chapter 3, this requires some specific thought for the IFSI because the IIFS may already be more vulnerable due to scale and structural liquidity

issues.⁹⁹ A tailored and considered recovery and resolution framework may be, in many ways, more important for the Islamic banking and finance industry than for the conventional banking and finance industry. That statement is made with full cognisance of the fact that recovery and resolution frameworks are considered to be critical for the conventional banking and finance industry.

With regards to the liquidation process, the IFH case is illustrative of the difficulties that arise in incorporating relevant Sharī'ah principles in an already established secular legal setting. Where no specific legal mechanisms are in place that help to ensure Sharī'ah cognisance, an IIFS may be treated in the same way as a conventional bank when going through the liquidation process. The consequences are often at odds with Sharī'ah mandates. It is not necessarily pragmatic to lobby a legislature to enact specific laws to remedy such issues. Nonetheless, targeted efforts should be undertaken. It is likely that those efforts will be helpful, but insufficient. What else can be done in this instance?

Many legal frameworks are highly deferential to contractually agreed arrangements. They usually give effect to the agreements of the contracting parties, unless those agreements are contrary to law or prevailing public policy, and, in the bankruptcy–insolvency context, subject to economic form-over-substance analysis. The development of Islamic financing arrangements in the private sector in many jurisdictions that do not take cognisance of the Sharī'ah is illustrative of using contractual arrangements to give effect to Sharī'ah-compliant arrangements even where the law does not expressly take cognisance of the Sharī'ah. Sharī'ah-compliant contracts are routinely enforced under English law and New York law. It is therefore advisable to structure contractual arrangements that address some, or many, of the recovery and resolution issues, and to structure those arrangements in a manner that is in compliance with Sharī'ah principles. These contractual arrangements will be given effect by the courts and, even where public policy concerns intervene, can provide critical guidance to authorities and courts that are implementing recovery and resolution programmes.

There are a number of issues that arise out of cases such IFH. The aim of the case study is to bring these to the surface so that policymakers can be aware of them when designing an insolvency regime for their IFSI.

⁹⁹ The authors recognise that the literature may differ in views with regards to IIFS being less or more prone to financial distress and crisis (Rajhi and Hassari's paper on unconventional banking systems in distress being an example).

5.3 Restructuring Issues for IIFS and Lessons Learned

The restructuring of debt and the various mechanisms that can be used are important to consider from a Sharī'ah perspective. Conventional debt restructuring allows for a continuation of the debt, as restructured, and may allow for an increase in the amount of debt, for an extension of the repayment periods of the relevant debt, and even for incurrence of new debt.¹⁰⁰ The relevant questions pertain to whether the debt restructuring and the term extensions constitute prohibited ribā. As previously discussed, debt cannot be extinguished other than by forgiveness by creditors or repayment. Imposed haircuts by a court or other relevant authority may not be compatible with Sharī'ah. Each situation will have to be analysed by Sharī'ah scholars under the facts of the specific case. Similarly, there may be issues around the sale of debt at a discount to, or in excess of, the face value which, in a restructuring context, may require more discussion and thought from Sharī'ah boards/scholars.¹⁰¹

IIFS may tranche their debt obligations with degrees of subordination. From a Sharī'ah perspective, while there exists a specific creditor hierarchy under generally accepted principles, there are opinions that subordination via the insertion of clauses and stipulations detailing write-down mechanisms is allowed. Where an entity is trying to reorganise itself and move back to a going concern status, voluntary subordination would be in the interests of helping to save the entity.

Restructuring may also involve debt-to-equity conversions. From a Sharī'ah perspective, this may be acceptable and readily achieved, especially with certain categories of contracts (i.e. *mushārah*) that are already regarded as equity and do not require any conversion from a Sharī'ah perspective. All that is required is for the local legal framework and mechanisms to enforce this conversion. A complexity may arise when these types of contracts are treated as debt instruments, rather than equity. Contractual provisions regarding the intention of the parties and applicable principles may assist in guiding any subsequent recovery, reorganisation, restructuring, resolution or liquidation process, including when courts become involved.

Two more issues may arise in connection with an IIFS restructuring: one is when a minority of creditors (or even a sole creditor) disagree with the formulated restructuring plan. Restructuring mechanisms may contain different stipulations with regards to acceptance of a reorganisation plan. The Bankruptcy Code in the US (Chapter 11), for example, states “acceptance”¹⁰² as being “*acceptance by holders of at least two-thirds in dollar amount and*

¹⁰⁰ From the basic concept of time value of money.

¹⁰¹ In reality, distressed/bankruptcy sales simply do not attract face value bids for the most part.

¹⁰² M. J. T. McMillen (2015). *The Arcapita Group Bankruptcy: A Restructuring Case Study*, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2687239

greater than one-half of allowed claims in that class". Furthermore, the Code allows for a plan to be confirmed if there has been non-acceptance by one of more impaired classes of claim, so long as the plan is "fair and equitable" in regards to the accepting parties. As has been discussed in Chapter 3 of this paper; Sharī'ah rules on *iflās* are strict in that debt must be repaid and can only be wiped with the express forgiveness of the creditor. Does this mean, then, that non-acceptance by a small group or, indeed, a single party can prevent the whole plan from going ahead? Also, if legal mechanisms such as Chapter 11 already allow for a plan to be effectively forced on dissenting minorities (qualified, in many cases, by a "fairness" threshold), can this render such mechanisms non-Sharī'ah-compliant?

The wider *maqāṣid al-Sharī'ah* has been discussed in this paper and again must be considered in regards to a restructuring exercise. Restructuring of debt following a bankruptcy (voluntary or otherwise) aims to satisfy the claims of the creditors in an effective, streamlined and consensual manner. Specifically, when we consider voluntary bankruptcies and protection from creditors, the aim of the whole restructuring process may also be to help move the failed entity from a gone concern, back to a going concern, while also upholding the rights of the creditors. Overall, if the process requires that some creditors be overruled by an authority (i.e. a court) with regards to a restructuring plan, the overarching "good" may be closer to the *maqāṣid* – namely, arriving at a practical and achievable solution that could result in the entity continuing to do business. There may be a difference of Sharī'ah opinions on this issue; again, it is important for Sharī'ah experts to be engaged from the outset of such a restructuring to deal with such matters, or indeed to discuss the issues in depth beforehand so that it is clear what mechanisms can be used.

Another potential strategy used in restructuring can be debt for asset swaps, which would transfer a debtor's assets directly to its creditors (including the management of their disposal). This could, in practice, then sever any legal ties between the two parties.

Swapping debt for an asset, if properly effected, may not present compliance issues from the Sharī'ah perspective. It is necessary to determine how the swap arrangements are structured before a definitive statement can be made. Questions may arise as to relative values of debt and of the asset, for example. It would seem that the issues may be minimised if the asset is of greater value than the debt for which it is swapped.¹⁰³

¹⁰³ Abū Hurairah reported: "A man demanded of the Prophet (ﷺ) repayment of a loan and was harsh to him. His companions were about to attack him, but he (ﷺ) said, 'Leave him, as the creditor is entitled to make a demand. Give him a camel of the same age as the camel that is due to him.' They said: 'We find a better camel senior to it in age.' He (ﷺ) said, 'Then buy it and give it to him; verily the best of you is the one who is the best in discharging his obligations (repayments of loans).'" (Al-Bukhārī and Muslim)

It should be noted that asset transfers are different from entity transfers (i.e. transferring business units/shares). The latter involves more risk and complex valuation requirements given that the entities may have debts, liabilities and other obligations. Transfer of actual assets, therefore (e.g. vehicles/properties), is generally more preferable.

This type of restructuring still depends upon creditor acceptance and approval. Such a remedy is interesting and should be further considered. It may be that it constitutes a permissible and acceptable sale. That will have to be explored. The concept of transferring ownership of assets to creditors in situations where cash repayments are not possible, while complicated, is worthy of consideration. Obviously, there are a raft of issues, including the effects such asset transfers may have on other creditors in the hierarchy. Whether or not the total sum of outstanding debt can be realised by every creditor through disposition of the asset is dependent on market conditions (and not, importantly, on a prearrangement at a fixed price). It is unlikely that all creditors can be satisfied from asset sales; the firm would not be in a stressed condition if that possibility was realistic. However, the tool may work to satisfy certain classes of creditors.

The aim of the discussion in this chapter is to emphasise the importance of recovery options for the IFSI that both comply with Sharī'ah principles and have a practical application within existing legal regimes. The IFH example shows how IIFS are vulnerable to economic shocks and banking crises. This can have knock-on effects for customers as well as contagion implications. The recovery and resolution issues detailed in Chapter 3 need further consideration and incorporation into the wider recovery and resolution framework being developed (currently or in the future) across jurisdictions.

Legal mechanisms (such as those similar to Chapter 11 in the US) allow for a more organised restructuring to take place and, importantly, afford the failed bank enough time while still safeguarding creditors. The terms of the restructuring need to adhere to Sharī'ah principles, such as debtors not being charged more for time delays in payment (which would be an embedded *ribā*). Ensuring that Sharī'ah is maintained during the process **is** a separate matter; as said previously in this paper, engagement with Sharī'ah experts/boards is recommended from an early stage and throughout the life cycle of a restructuring process.

Restructuring terms themselves also give rise to a number of Sharī'ah complexities. These also need to be considered, ideally by the court; alternatively, there should be some mechanism afforded to the process that allows Sharī'ah experts to be consulted to ensure compliance with Islamic principles. It should be noted, however, that the overarching *maqāṣid al-Sharī'ah* allows for flexibility when the overall aim is beneficial to society (i.e. trying to help rescue an entity and allow it to move back to being a going concern, and/or enforcing a restructuring plan that is pragmatic and provides a remedy sooner rather than later).

Considering such examples may help RSAs and governments to better understand Sharī'ah principles and their potential application in stress situations that involve recovery and resolution mechanisms. An informed framework for dealing with these complexities is required for financial stability and contagion prevention purposes.

CHAPTER 6: CONCLUSION AND NEXT STEPS

Financial safety nets are designed to safeguard a financial system, and thus to ensure that the wider economy does not suffer adversely from banking collapses. The GFC brought to the surface just how detrimental bank failures can be, with the social, economic and political ramifications still being felt a decade on. Policymakers have the unenviable task of maintaining a competitive landscape for financial services that still allows banks to fail, but in an orderly manner.

Recovery and resolution planning is designed to help banks identify options to restore their own viability should they face a stress event. Importantly, the process is primarily pre-emptive; strategies are identified and analysed during normal business conditions along with how they are to be executed. Under a severe stress scenario, quick and decisive action can be the difference between insolvency and stabilisation. Recovery planning facilitates this decisive action. Banks that have carried out a thorough stress-testing process may find accuracy in their estimated outflows and haircuts, giving a degree of familiarity during the stress event which can then be dealt with more effectively.

Resolution asks banks to assess what method is best for their own wind-downs, and to identify any impediments to such a process. Resolution authorities themselves can use these assessments along with their own analysis to ensure that an orderly wind-down of a bank takes place, reducing any adverse impact on the wider system (and economy), as well as reducing moral hazard by allowing even the largest banks to fail.

Recovery and resolution regimes are still developing globally, and while having a significant regulatory focus, the nature of financial stresses and economic volatility is both largely unpredictable and can be extremely severe. Recovery and resolution aims, along with other financial safety nets, to mitigate such difficulties as far as possible. The workings of a robust recovery and resolution framework can be found from global regulatory standards and best practice. This paper has established, based on the FSB's Key Attributes and the US/European experience, the following as some of the key features of an effective recovery and resolution framework:

- a single appointed authority that will lead on bank resolution;
- the resolution authority to have a consolidated set of powers and tools at its disposal (as covered in Chapter 2);

- requirements for banks to create (yearly) recovery and resolution packs, which should contain capital and liquidity recovery options with quantified haircuts and trigger points;
- identified individuals within the bank who will be responsible for executing various aspects of the recovery plan; and
- resolution planning to be carried out by the resolution authority during normal business cycles, especially with regards to G-SIB entities.

The criteria above are general, in that they cover all banks. For IIFS, recovery and resolution becomes more complex due to the specificities of the industry, its structural nuances, and the overarching demands of Sharī'ah on how contracts and transactions must be structured and implemented. As Chapter 4 of the paper has shown, a number of jurisdictions already have in place aspects of the above criteria; however, there does not appear to be any specific framework or thinking for the Islamic finance model in dual jurisdictions. Given that Islamic banking makes up a systemically important portion of the financial system of 12 jurisdictions, it is of particular importance that policymakers and regulators incorporate the needs and challenges of IIFS with regards to recovery and resolution into their national frameworks.

Chapter 3 of this paper first establishes the general principles of Islamic *iflās*. Importantly, *iflās* does not allow debt to be extinguished by any means other than through the express forgiveness of the creditor. This is a key principle when dealing with bail-ins, asset sales, and asset transfers for IIFS. The chapter does, however, find that this stringency is tempered by certain moral recommendations; namely, that it is better to afford a debtor time so that they can repay, or ultimately to forgive them their debt if they cannot. While this paper recognises that, in today's corporate paradigm, consistent debt forgiveness can have disastrous effects with regards to profitability and solvency, the wider *maqāṣid al-Sharī'ah* seems to be that helping an entity recover itself, whether through affording time, restructuring or similar means, is preferred. The rights of creditors must be upheld; however, there can be practicality and flexibility in the Sharī'ah for the wider good.

Chapter 3 then goes into detail with regards to capital and liquidity recovery options, as well as resolution strategies such as bail-ins and asset transfers/bridge banks. Importantly, this analysis has examined the various strategies from both a Sharī'ah and a practical/operational perspective. The key findings of this chapter are as follows:

- Asset sales during a stress event are distressed, and haircuts are likely (even if price dislocation is something a robust framework will try to minimise). A majority of Islamic

bank assets are debt in nature (*murābaḥah*). Sharī'ah does not allow the sale of debt at less than par, and this could seriously impinge the use of this recovery option.

- Jurisdictions with small Islamic finance sectors may find that a market-wide stress event impacts all their IIFS in a similar way. This may lead to a scenario where all the IIFS are trying to sell similar assets simultaneously in a market and there are no natural buyers.
- Central bank liquidity facilities such as lender of last resort are largely not developed in a Sharī'ah-compliant way.
- Intragroup support can take on various structures in terms of liquidity downstreaming; if the apex entity is a conventional bank, the funds would need to be given in a Sharī'ah-compliant manner. Similarly, certain contracts, such as a *qarḍ*, cannot be subordinated, so thought is required as to what type of funding is being provided.
- Regulatory bail-ins through write-downs by an RSA should be straightforward for equity-like capital instruments (*mushārakah/muḍārabah*) provided that the write-downs are the result of losses linked to the assets financed by the (*mushārakah/muḍārabah*) capital. However, the issue of unilaterally writing down debt structures or waiving ownership claim without the explicit consent of the *ṣukūk* holders arises. Furthermore, the insertion of clauses and stipulations detailing write-down mechanisms in debt structures or the waiving of ownership claims in *ijārah* assets may also raise Sharī'ah issues.
- Asset transfers/bridge banks could be done with conventional counterparts (especially if the IIFS are small in number); however, Sharī'ah governance and compliance would need to be upheld.
- PSIAs are closely aligned to the asset management model. Transfer or sale of such assets to a conventional asset manager who has operational capacity to run them may be an option; however, the same issue of Sharī'ah governance and compliance arises.

The complexities brought forward by the Islamic finance model give rise to a number of operational and structural challenges when dealing with both recovery and resolution. Chapter 3 goes into granular detail with regards to these and has also offered some solutions/alternatives. The main conclusion, however, and one of the most important messages in this paper, is that further thinking from Sharī'ah scholars/boards is needed when dealing with an Islamic bank in stress, as opposed to normally accepted Sharī'ah principles and practices.

This paper has sought principally to bring these issues to the surface and to make the reader aware of them in the context of a recovery and resolution scenario. For policymakers who are looking to design a recovery and resolution framework for their Islamic finance market, engagement should be made with Sharī'ah experts from the outset, so that these issues can be properly discussed and remedied. Similarly, resolution authorities who will be leading on both conventional and Islamic resolutions will need Sharī'ah expertise and guidance. This may be internally built (in certain jurisdictions where the Islamic finance sector is more developed), or there may be appointed Sharī'ah experts on whom the authority can rely. Islamic banks that are creating their RRP packs must also engage their Sharī'ah boards in the process, given the issues and challenges discussed.

The paper emphasises that many of the Sharī'ah issues and principles that have been applied to the capital/liquidity recovery options are “business as usual”. A recovery scenario represents abnormal conditions, and it is within this context that decisions around Sharī'ah need to be made. From an operational perspective, distinct recovery and resolution strategies for IIFS may be needed in certain jurisdictions given the size of the sector. This may require engagement with the wider conventional market and, again, any Sharī'ah issues around this must be resolved early so that a viable plan can be formulated.

As the survey report in Chapter 4 has shown, recovery and resolution frameworks are in their infancy across most IFSB member jurisdictions (especially for IIFS). This can be an advantage for the industry and for policymakers; it allows for a framework to be built with consideration for IIFS from the outset. Incorporating such changes after a framework has already matured can be more problematic, inefficient and difficult, and is likely not to be comprehensive or entirely consistent.

It is important to bear in mind that the success of a recovery and resolution framework is also hinged on mechanisms such as lender of last resort and deposit insurance (as evidenced clearly by the Ihlas Finans House case in Chapter 5). National policy will dictate whether Sharī'ah-compliant versions of these mechanisms can be created (and when). However, the importance of these tools is key for both conventional and Islamic banks in a stressed environment. Concentrated outflows of liquidity can be mitigated somewhat (at the retail book level) through deposit insurance. Similarly, where needed, a failing entity can rely on a guaranteed liquidity injection from its central bank should all other options fail it. Policymakers and Sharī'ah scholars should think about the use of such mechanisms for the wider good of the IIFS and its customers, even if for the present moment Sharī'ah-compliant versions are not available.

Another important take-away of this research paper, and one which is again evidenced in the Ihlas Finans House case study, is that the most material risk in terms of causing failure for IIFS is liquidity. This is the same as for the conventional market, and global regulatory focus has shifted heavily onto liquidity risk management – more so following the GFC. For the Islamic finance sector, liquidity has been an ongoing structural challenge given the lack of secondary trading in *ṣukūk* and the absence of a deep interbank or repo market. Importantly, when assessing quantifications on the liquidation of high-quality assets, regulators and IIFS themselves must be aware that there is simply less historical data on many of these products. There are also fewer natural buyers, as opposed to bonds. How these products will behave in a stressed market is thus not clear. Prudence in this regard is therefore important when recovery planning for IIFS. Again, this is a consideration for an IFSI recovery and resolution framework.

Ultimately, this paper has been written with the aims of shining a light on a number of legal, structural and operational issues in the context of recovery, resolution and insolvency for IIFS, and of making policymakers aware of these challenges. It represents the final paper in the IFSB's working paper series on financial safety nets. This is the IFSB's first detailed look at recovery, resolution, insolvency and restructuring issues for IIFS. The IFSB may, moving forward, look to issue a Guidance Note on this subject, offering more specific advice in this area.