16th
Islamic Financial Stability Forum

Recovery, Resolution and Insolvency for Institutions Offering Islamic Financial Services (IIFS)

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16th IFSF : Speaker & Discussants

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RECOVERY, RESOLUTION, AND INSOLVENCY:
CRITICAL ISSUES FOR ISLAMIC FINANCIAL INSTITUTIONS

16TH ISLAMIC FINANCIAL STABILITY FORUM

11 DECEMBER 2017
KUALA LUMPUR, MALAYSIA

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• Focus on a few practical issues relating to the implementation of a recovery and resolution regime that is responsive to Islamic financial institutions.

• A select group of issues, posed as questions (without answers), and presented to generate thinking and discussion.
• Two important threshold concepts:
  • Recovery – Resolution
  • Bankruptcy – Insolvency
RECOVERY AND RESOLUTION

• **Recovery**: of capital or liquidity position:
  • Recapitalization.
  • Reorganization.
  • Restructuring.
  • More harmonious with Shari‘ah principles.

• **Resolution**:
  • Stabilization.
  • Winding down and liquidation.
SYSTEMS: BANKRUPTCY AND INSOLVENCY

• **Bankruptcy:**
  • Debtor orientation.
  • Reorganization and preservation of the business.

• **Insolvency:**
  • Liquidation for creditor benefit.

• **Where on the continuum is a given system?**

| Bankruptcy | Insolvency |

• **Can the system be used to effect a more bankruptcy-like approach?**
• Shari‘ah expertise
  • Regulatory authority
  • Contracts
• Asset sales
• Lender of last resort facilities
• Regulatory authority powers
• Recovery plans
SHARI‘AH EXPERTISE - REGULATORY AUTHORITY

• Working paper makes suggestions regarding the recovery and resolution regime and framework for Islamic financial institutions and countries in which they operate.

• Most jurisdictions, a single resolution authority will have jurisdiction over both Islamic and non-Islamic institutions.
  • National deposit insurance providers are emerging as the preferred regulatory supervisory authority.

• In most instances in mixed systems, it is likely that Shari‘ah knowledge and experience is either absent or inadequate in the regulatory supervisory authority.
SHARI‘AH EXPERTISE - REGULATORY AUTHORITY

• Internal or External?

• Internal:
  • How to hire and train internal experts?
  • Budgetary, political, and other constraints?

• External:
  • Legal foundation to hire?
  • Criteria and qualifications?
  • Governance, and authority of external advisors?
  • Budgetary, political, and other constraints?
SHARI‘AH EXPERTISE - CONTRACTS

• Classification of contracts will be critical.

• Equal treatment for equal risk positions is fundamental.
  • Equity absorbs losses first.
  • Then subordinated debt.
  • Then unsecured creditors.
  • Depositors last.
SHARI‘AH EXPERTISE - CONTRACTS

• **Who will classify** Shari‘ah-compliant instruments and arrangements?

• **What criteria** will be used to classify Shari‘ah-compliant instruments and arrangements?

• **Should a standard setting organization** within the Islamic finance industry take the lead in classifying instruments and establishing criteria and methodologies?

• Consider profit sharing investment accounts, among others. Are these to be investment contracts with no claim on bank assets? Jurisdictional variations.
ASSET SALES

• Given the size of the Islamic finance industry, it is quite possible that all Islamic financial institutions will be experiencing a major stress event simultaneously.

• Sales of assets (of a distressed institution) to other Islamic financial institutions and bridging arrangements with other financial institutions will then be unlikely or impossible.

• A possible solution involves asset sales to non-Islamic financial institutions.
ASSET SALES TO NON-ISLAMIC INSTITUTIONS

• **What issues** arise if assets sold to non-Islamic institutions and how are they to be addressed?
  
  • Potential purchasers: banks; investment funds for profit sharing investment accounts. **Commingling** of funds.
  
  • Ensuring **on-going Shari‘ah compliance**? Who and how?
  
  • **Contract novation issues** and **preservation of Shari‘ah compliance**.

• **Should standards be developed**? If so, what effect on valuations and pricing of the sold assets?

• How to address the **illiquid asset problem** (real estate, ijara, household financing)?
ASSET SALES OF DEBT OBLIGATIONS

• Most Shari‘ah-compliant assets are debt obligations.
• Cannot be sold except to the debtor or at par: impractical.
• Are dispensations appropriate, in the transition phase?
• What alternatives can be developed?
  • Debt-commodity swap? Is it tawarruq?
• What mechanisms available for intra-group support where the Islamic bank is part of a group that includes non-Islamic entities?
  • Vector murabaha may be impermissible tawarruq.
  • Guarantees: fee issues (and group bankruptcy issues).
LENDER OF LAST RESORT

• Stress resolution and recovery frequently entails resort to the lender of last resort.

• Liquidity crises are the most common stress.

• There are very few Shariʿah compliant lenders of last resort.

• Existing lender of last resort facilities are interest-based and not Shariʿah compliant.

• Only six countries have Shariʿah-compliant facilities.
LENDER OF LAST RESORT

• As a matter of transition, when, if ever, can Islamic financial institutions utilize non-Islamic lender of last resort facilities under doctrines of necessity?

• If so, how can an Islamic financial institution utilize non-Islamic lender of last resort facilities?

• What factors are relevant to this inquiry?

• What constraints should be implemented in these scenarios (if they can be used at all)?
LENDER OF LAST RESORT

• Reserve accounts may work.

• Central bank facilities are interest-based. Qard? Murabaha?

• Mudaraba arrangements: central banks taking equity risk, which exposes public credit.

• Access of Islamic financial institutions to central bank open market operations.
REGULATORY AUTHORITY POWERS

• Regulatory supervisory authorities (recovery and resolution authorities) have considerable powers, including:
  • Replacement of management.
  • Appointment of receivers.
  • Contractual termination and assignment.
  • Overrides of shareholder rights.
  • Sale or transfer of assets and liabilities.
  • Establishing asset management vehicles.
  • Bail-ins (conversion of debt to equity).
  • Payment moratoria.
  • Wind-downs and liquidations.
REGULATORY AUTHORITY POWERS

• Should Shari‘ah considerations be constraints on authorities?

• How would the constraints be determined (by whom and when and by what mechanism)?

• How would the legal mandate be obtained and implemented?

• Could the regulatory supervisory authority change the Shari‘ah scholars advising the Islamic financial institution?

• Should a standard setting authority within the Islamic finance industry take the lead in trying to develop criteria or standards in this regard?
RECOVERY PLANS

• Each financial institutions should develop (and stress test) a recovery and resolution plan.

• They are individualized to the institution, in large part.

• The must be responsive to each institution’s systemic footprint, business model, risk profile, and organizational structure.
RECOVERY PLANS

• Should one of the standard setting bodies within the Islamic finance industry establish a consultative body to assist Islamic financial institutions in preparing RRP s?

• What degree of standardization should be attempted across institutions (recognizing the ultimate individuality of an RRP as to structure, risk profile, systemic footprint, etc)?

• What types of factors, if any, should be standardized (or at least harmonized generally)?
  • For example, with respect to changes in Shari‘ah governance or Shari‘ah rulings? These types of factors are not relevant for non-Islamic institutions. Are they appropriately considered?
• Resolutions
• Liquidation – investment accounts
• Liquidation – profit smoothing
• Sukuk and capital markets
• Sukuk and true sale
**RESOLUTIONS**

- Bail-ins: cancel shares, dilute or transfer shares, write down claims of unsecured creditors.

- Some Shari‘ah structures that constitute equity are amenable (musharaka). No contingent convertible (CoCo) sukuk as yet.

- Write downs are difficult: need creditor consent.
  - ISRA concerns on wa’d or ijara – looks like a loan combination.
  - Can an expediency exception be used (e.g., for sukuk)?
  - What criteria would be applicable and how effected and enforceable?
  - Hiwalah (assignment to another debtor): both sides of balance sheet.
LIQUIDATION - INVESTMENT ACCOUNTS

• Profit sharing investment accounts: restricted and unrestricted. Often mudaraba arrangements.

• Attention to placement in the creditor hierarchy: equity or deposit (for example). For both principal and returns.

• Should they be excluded from the bankruptcy estate of the Islamic financial institutions? Shari‘ah principles perspective.

• Or should they be within the bankruptcy estate but provided a preferred (deposit) distribution? Public policy perspective.

• Unrestricted: commingling raises difficult issues.
LIQUIDATION - PROFIT SMOOTHING

• Profit smoothing reserves: profit from an earlier period.
  • PER: Profit equalization reserves: contains both bank and customer profits.
  • IRR: Internal risk reserve: all customer funds (after bank share taken)

• Should public policy make these available to bank’s creditors? Or only to investment account holders? Are investment account holders “depositors”? Related questions.

• Different treatment: may need agreed ratios to treat PER reserve.

• Clear guidance to liquidation court or authority is needed.
SUKUK AND CAPITAL MARKETS

• Two different sets of issues:

• **True sale issues** (minimal discussion in Working Paper).

• **Capital classification issues** (CET1, AT1, T2; which are discussed in the Working Paper).
  
  • Working paper section 3.4.2.1 for types of structures (CET1, AT1, T2), particularly regarding conversion to equity.

  • Shari‘ah compliant structures may cross category boundaries. Example, whole business wakala and mudaraba sukuk (AT1 or T2) have musharaka characteristics (CET1).

  • Need to focus on these considerations.
SUKUK AND TRUE SALE

• If there has not been a “true sale” for secular bankruptcy law purposes, the assets have not been sold and remain in the bankruptcy estate of the seller.
  
  • Bank sukuk issuers: assets are always those of the bank (not the sukuk holders). Often unsecured general obligations (or nominally secured, without perfection). In stress, write-down of the repurchase price may occur (i.e., at less than outstanding principal).
  
  • Bank as sukuk holder: the assets are virtually always those of the issuer, not the bank, in an issuer bankruptcy.

• As an industry, we need to focus more on true sale considerations.
SUKUK AND TRUE SALE

• Not a true sale: Bank issued sukuk: Will be general obligations of bank.
  • Unsecured general obligations.
  • Nominally secured but unperfected obligations.
  • Write downs: the bank’s repurchase obligation might be written down.
  • But this would require sukuk holder (creditor) consent under the Shari‘ah principles. Even pre-consents are problematic: combining a loan with a sale.

• As an industry, we need to focus more on true sale considerations.
CONCLUSION
START NOW AND COORDINATE
SHARI‘AH BOARD PARTICIPATION

• Shari‘ah board participation at two levels:
  • Regulatory supervisory authority (resolution authority).
  • Individual Islamic financial institutions.

• Must be involved from the beginning: to develop a resolution and recovery plan that can be implemented immediately in a stress scenario.

• Should the regulatory supervisory authority have its own Shari‘ah board that acts throughout, including during the recovery and resolution proceedings?
STANDARD SETTING ORGANIZATIONS

• Good news: the IFSB has begun, it has taken the first steps.
• Working paper is a beginning.
• Need to carry the effort forward and think more rigorously about the unresolved issues.
• Need to mount an effort to do so in coordination with the relevant secular authorities.
THANK YOU