Effective Insolvency Regimes: Institutional, Regulatory and Legal Issues Relating to Islamic Finance

Islamic Financial Services Board
The World Bank
2011
ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

The IFSB is an international standard-setting organisation which was officially inaugurated on 3rd November 2002 and started operations on 10th March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which involves, among others, the issuance of exposure drafts, holding of workshops and where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

For more information about the IFSB, please visit www.ifsb.org

ABOUT THE WORLD BANK

The World Bank was established in 1944 and its mission is to fight poverty with passion and professionalism for lasting results and to help people help themselves and their environment by providing resources, sharing knowledge, building capacity and forging partnerships in the public and private sectors. The World Bank is not a bank in the common sense; as it is made up of two unique development institutions owned by 187 member countries: the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA). Each institution plays a different but collaborative role in advancing the vision of inclusive and sustainable globalization. The IBRD aims to reduce poverty in middle-income and creditworthy poorer countries, while IDA focuses on the world’s poorest countries. Their work is complemented by that of the International Finance Corporation (IFC), Multilateral Investment Guarantee Agency (MIGA) and the International Centre for the Settlement of Investment Disputes (ICSID). The World Bank provides low-interest loans, interest-free credits and grants to developing countries for a wide array of purposes that include investments in education, health, public administration, infrastructure, financial and private sector development, agriculture and environmental and natural resource management. The World Bank is headquartered in Washington, D.C. and has more than 10,000 employees in more than 100 offices worldwide.

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FOREWORD

In the name of Allah, the Most Gracious, the Most Merciful.

Recent developments in the global economy have prompted new work on legal, institutional and regulatory issues relating to insolvency regimes for conventional banks. Given the rapid expansion of the Islamic financial services industry (IFSI) and the increasing trend of cross-border trades in these services, it is equally critical that regulatory authorities are aware of, and become well versed in addressing, issues in relation to insolvency regimes for Islamic finance. Further, the defaults of certain Sharī‘ah-compliant financial instruments during the recent global financial crisis made industry stakeholders realise the importance of having an adequate insolvency regime that is consistent with Sharī‘ah and is benchmarked against best international practices.

In response to this issue challenge, and pursuant to a broader the Memorandum of Understanding that was signed in November 2009 between the Islamic Financial Services Board (IFSB) and the World Bank (WB), it was agreed that an IFSB–WB Roundtable Discussion on “Effective Insolvency Regimes: Institutional, Regulatory and Legal Issues Relating to Islamic Finance” would be held in October 2010 in Washington D.C. and the results of the Roundtable Discussion to be published in a book. The IFSB requested Mr Hamid Yunis, Partner of Taylor Wessing in the UK to present at the Roundtable Discussion an Issues Paper on the topic of insolvency issues for Islamic Finance. Various legal and Sharī‘ah experts were also asked to submit commentaries on the topic, and a number of central banks who are members of the IFSB were asked to comment on their experiences in managing insolvency proceedings for Islamic financial institutions within their own jurisdictions.

This book is based on the structure of the IFSB–WB Roundtable Discussion. It is hoped that the book will enlighten industry stakeholders and provide them with a better understanding of the issues surrounding the insolvency regimes that should be developed for the IFSI.

The book starts with the Opening Remarks of Mr. James Adams, Vice President for the East Asia and Pacific Region of the World Bank. It is followed by Chapter One, which is the Issues Paper written by Mr Hamid Yunis.

Chapters Two and Three consist of commentary papers by experts and Central Banks, respectively. The first expert commentary is by Mr Michael McMillen while the second expert commentary is by Dato’ Dr Nik Ramlah Nik Mahmood and Mr Wan Abdul Rahim Kamil. Meanwhile, Chapter Three features three commentary papers from three Central Banks from among the IFSB member countries – the State Bank of Pakistan, Bank Indonesia and Saudi Arabian Monetary Agency.

Chapter Four by Ms Sau Ngan Wong and Mr James Seward from the World Bank provides an analytical framework on challenges and issues relating to insolvency regimes in Islamic finance and Chapter Five provides a synthesis of the comments, discussions and Q&A session during the Roundtable Discussion, Dr Tunc Tahsin Uyanik provides concluding remarks at the conclusion of the Roundtable Discussion and the final section, provides some thinking on the way forward on the issues raised during the Roundtable Discussion.

In Chapter One, Mr Yunis focuses on the way insolvency issues affect Sharī‘ah-compliant transactions. He highlights the issues surrounding the recognition of Sharī‘ah by courts in conventional legal systems. He also discusses the need to consider the specificities of the contracts used in Sharī‘ah-compliant transactions, when considering specific insolvency arrangements in Islamic finance. The chapter further discusses issues that would arise in
the event of insolvency, and provides some recommendations on how to prevent disputes arising from insolvency. The chapter is supported by relevant case studies.

In the first expert commentary paper, Mr Michael J.T. McMillen deliberates on Shari‘ah considerations in the context of bankruptcy and describes how the insolvency of Islamic financial instruments, in particular the East Cameron oil and gas Sukūk, has been managed. He summarises various Shari‘ah principles that are applicable in the bankruptcy and insolvency context, and describes the secular bankruptcy and insolvency regimes, particularly in jurisdictions that have adopted a reorganisation (or “Chapter 11”) restructuring methodology. Finally, the paper considers aspects of the bankruptcy proceedings involving the East Cameron oil and gas Sukūk as an example of a secular bankruptcy/insolvency proceeding involving a Shari‘ah-compliant instrument and transaction.

The second expert commentary paper, by Dato’ Dr Nik Ramlah Nik Mahmood and Mr Wan Abdul Rahim Kamil, comments on the main Issues Paper by providing an overview of Shari‘ah law and its views on insolvency. The paper categorises the basic models of Islamic financing contracts, describes the implications of each in the event of a default, and makes practical suggestions for preventing problems that commonly occur during insolvency proceedings involving Islamic finance. The Shari‘ah consequences in cases of settlement of bankruptcy proceedings are also discussed.

In Chapter Three, the first commentary paper by Mr Inayat Hussein of the State Bank of Pakistan highlights issues and challenges in constructing adequate insolvency regimes for Islamic finance. Experiences in establishing Islamic banks in Pakistan, as well as the legal and regulatory framework for Islamic banks in the country, are also discussed. The author also touches on the establishment of the Shari‘ah Court to ensure that all legislation in Pakistan complies with Shari‘ah. The paper proposes some issues that should be considered in developing comprehensive insolvency regimes that cater to the specificities of Islamic finance – for example, the position of investment account holders, liquidation of Shari‘ah-compliant assets, and the treatment of Profit Equalisation Reserves.

In the second commentary paper, Dr Dadang Muljawan from Bank Indonesia takes a closer look at the importance of the prevention of insolvency. In addition to describing the background and characteristics of Islamic banks in Indonesia, he highlights possible regulatory approaches for insolvency based on the characteristics of the deposits, considers the economic justification for the cost of bailing out insolvent Islamic banks, and examines means to prevent insolvency, such as the establishment of a Crisis Management Protocol. From the regulatory point of view, this paper also describes the Indonesian experience in terms of how Shari‘ah is applied and made binding in the existing legislation and regulations.

The third commentary paper presents comments from Dr Mohammed Al-Sheabi from the Saudi Arabian Monetary Agency. Dr Al-Sheabi provides a detailed description of the structure of the legislation regulating Islamic finance and insolvency regimes in Saudi Arabia. He voices his concern that issues relating to insolvency regimes for Islamic finance are seldom being addressed adequately. The author emphasises the importance of having adequate insolvency resolutions for the industry to mitigate the risks in relation to insolvency of IIFS prevent potential issues in future.

In Chapter Four, Ms Sau Ngan Wong and Mr James Seward from the World Bank provide an analysis of the challenges facing the regulatory and supervisory authorities in updating the regulatory frameworks in order to develop comprehensive insolvency procedures that cater for to the specificities of Islamic finance. The chapter analyses the challenges in relation to the legal, regulatory and institutional issues in relation to insolvency of IIFS and suggests several possible approaches in order to resolving these issues and problems surrounding insolvency regimes for Islamic finance.
Chapter Five provides a synthesis of the comments and discussions from the questions and answers session during the Roundtable Discussion. The issues generated from the session are summarised into four domains: i) lack of clarity in documentation of Islamic financial transactions, which creates issues in assignments of obligations and rights, and raises the degree of legal risks in Islamic finance transactions; ii) issues related to courts not recognising, and judiciary not understanding, Islamic finance and Sharī‘ah-based transactions; iii) insolvency of IIFS as compared to insolvency of Islamic financial transactions; and iv) the question whether insolvency regimes for conventional finance can be applied to Islamic finance.

We wish to note our appreciation to the honourable governors of Bank Indonesia, the State Bank of Pakistan, Saudi Arabian Monetary Agency and the Central Bank of the United Arab Emirates for their support in allowing resources and the sharing of information for the purpose of the Roundtable and this publication. We also wish to thank Mr. James Adams, Vice President, East Asia and Pacific Region of the World Bank, for his encouragement and support of the Roundtable Discussion.

The IFSB and World Bank would also like to acknowledge the efforts of the participants at the Roundtable Discussion as well as the contributors of this book whose insights have enriched the discussions during the Roundtable. The high quality of presentations, significant interest in exchanging ideas during discussions and substantial participation from regulators and experts alike were gratifying for those of us involved in organising the Roundtable. We are also indebted to those who have helped in making the Roundtable and the publication of this book possible. In this regard, we wish to record our thanks to Abdelilah Belatik, Assistant Secretary-General of the IFSB, Siham Ismail, Ronald Rulindo and Yazmin Aziz from the IFSB Secretariat; James Seward, Sau-Ngan Wong, Aira Maria Htenas, Jiyoung Song, Mia Oh and Diane Brown-Smith from the World Bank and Dato’ Latifah Merican Cheong, consultant to the World Bank, for providing all the support necessary in ensuring the Roundtable a success and making the publication of this book possible.

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March 18, 2011
ABOUT THE CONTRIBUTORS

Dr Dadang Muljawan graduated from the Engineering Physics Department, Bandung Institute of Technology, in 1992. He earned his MBA in Finance from PPM Graduate School of Management in 1995 and a PhD in Economics from Loughborough University in 2002. Currently, he is an economic researcher with Bank Indonesia. Dr Dadang has written a number of research papers and central bank working papers, which have been published in international journals. His areas of research cover financial regulation, monetary policy, and financial risk management. He has also contributed to a series of international seminars in the area of financial regulation.

Mr Hamid Yunis is a senior partner of the international law firm Taylor Wessing, based in the City of London office. Having trained as a corporate finance lawyer since the mid-1990s, Mr Yunis has been involved in the successful structuring, negotiation and financial close of a number of major projects – specifically, project-financed transactions – globally. Mr Yunis also has a number of management roles within Taylor Wessing and heads up, from London, the firm's Middle East Group, which includes its Gulf-based lawyers.

Mr Yunis leads Taylor Wessing's well-known Islamic Finance Group. He has led legal teams on a number of market-leading transactions, including acting for the Dubai government on its EMTN, MTN and Sukūk issues. He has also acted on a number of Islamic finance transactions, which have included the use of Islamic structures for property development, project finance, trading activities (including private equity and hedge funds) and the use of Islamic investment/funds products.

Mr Yunis is recognised by The Legal 500, Chambers and Legal Business as a leading expert in the legal field. He is also a regular contributor to the legal industry forum and publications.

Mr Inayat Hussain is the Executive Director of Banking Policy & Regulation Group, State Bank of Pakistan. His current responsibilities include developing a robust regulatory mechanism and its proactive surveillance through adequate measures underpinning the soundness and stability of the country’s banking system. As Executive Director, he is responsible for functional areas such as the Banking Policy & Regulations, Banking Surveillance, Islamic Banking and Consumer Protection departments. He is also a member of several senior-level committees at the bank.

Mr Inayat’s central banking career has spanned 18 years. He has served in various important positions in areas of banking inspection, supervision, and policy and regulations. Before his elevation to the post of Executive Director in September 2009, he served as Director of the Banking Inspection Department, where he managed and oversaw the on-site examination of banks and developmental financial institutions. He also dealt with issues pertaining to anti money laundering and combating the financing of terrorism. He worked closely with various international consultants in the preparation of an Examination Manual, Offsite Surveillance Manual and Problem Bank Management Manual, and spent a period on secondment to the Financial Services Authority in the UK.

Mr Inayat has attended numerous international seminars, conferences and training programmes on various financial issues – “Monetary and Financial Law”, “Regulatory Examination for AML and CFT of Financial Institutions”, “Creditor’s Rights in Emerging Economies”, “Risk Management for Central Bankers” and “Overseas Banking Supervision” – arranged by internationally renowned and prestigious organisations. Mr
Inayat is an MBA (Finance) and an Associate member of the Institute of Cost & Management Accountants of Pakistan and a member of the Institute of Bankers of Pakistan.

Mr James Seward is a Senior Financial Sector Specialist for East Asia and Pacific Region at the World Bank. He works on financial sector development issues in the East Asia and Pacific region. During the past seven years, he has worked on a range of financial sector policy issues, including financial stability, banking reform, strengthening supervision, building financial markets and competitiveness, and expanding access to finance. Mr Seward has led numerous technical assistance, analytical and lending operations in the East Asia region, which has given him a deep understanding of the issues confronting emerging market countries. He has worked on the aforementioned policy matters in many different contexts – from some of the largest economies in the world such as China and Indonesia, to some of the more under-developed economies, including Cambodia and Vietnam. He has also covered other regions outside of Asia, including North Africa and Eastern Europe.

Mr Seward joined the World Bank in 2002, first joining for a brief period as a consultant with the Financial Sector Development Department in the Europe and Central Asia Region. He then moved to one of the most active World Bank field offices in Hanoi, Vietnam in 2003 and returned to Washington, DC to take on a more regional portfolio in 2005. His prior professional experience was with the US Treasury Department on economic and financial sanctions compliance, inspections and enforcement, and with the US State Department working on foreign policy towards Egypt and North Africa. He has also been a consultant to different organisations, including one of the world’s largest microfinance banks (Bank Rakyat Indonesia) and a leading research institute in international development (the Harvard Center for International Development). Mr Seward has a graduate degree from the Kennedy School of Harvard University and an undergraduate degree in business administration and political science from James Madison University.

Mr James W Adams is Vice President for the East Asia and Pacific Region of the World Bank. In this capacity, he has overall responsibility for World Bank strategy, operations, and partnerships in one of the world’s most dynamic regions, covering more than a dozen states, ranging from the world’s most populous country to the smallest and most remote Pacific Islands states.

Previously, Mr Adams was Vice President and Head of Network, Operations Policy and Country Services at the World Bank. He was responsible for operational policy development, procurement and financial management activities, relations with United Nations and non-governmental organisations, and support to regional staff working in all these areas. Since joining the Bank in 1974, he has held a variety of operational positions in East Asia, Latin America, and Sub-Saharan Africa, including Country Director for Tanzania and Uganda, Director for Operations Policy, and Division Chief of several departments.

Before joining the Bank, Mr Adams worked for Merchants Bank, in Syracuse, NY, and with the General Agreement on Tariffs and Trade, in Geneva, Switzerland. Mr Adams studied at Colgate University, and holds an MPA from Princeton University.

Dato’ Latifah Merican Cheong is Advisor in the Chairman’s Office, Securities Commission of Malaysia and a Consultant for the World Bank. She also serves in an advisory capacity in the National Economic Advisory Council (NEAC), set up by the Prime Minister of Malaysia in 2009. Dato’ Latifah Merican Cheong was the Programme Director of the Financial Market Integrity Unit of the World Bank in 2004-2008, following
early retirement from the position of Assistant Governor at Bank Negara Malaysia (Central Bank of Malaysia).

At the World Bank, Dato’ Latifah Merican Cheong supervised a team of legal and regulatory experts in product development, including the methodology for review of bank corporate governance, bank assessment models and insolvency regimes. She also led the World Bank work on policies, compliance assessment and technical assistance on anti-money laundering regimes and combating terrorism financing.

Dato’ Latifah Merican Cheong has more than 30 years experience in financial and economic policy management. At Bank Negara Malaysia, she had direct responsibility on macro-economic management, and led several teams involved in policy design and implementation in the services sector and in financial sector development, including exchange control matters. Other experiences include institutional and structural reforms, leading financial services trade negotiations, financial sector product and infrastructure development and international financial relations.

Dato’ Latifah Merican Cheong was an Alternate Executive Director in the Executive Board of the International Monetary Fund in 1994-1996. She studied at University Malaya and Vanderbilt University, Tennessee, USA.

Mr Michael J.T. McMillen is a member of the bar of the State of New York. He was the founding chairman and a past chairman of, and is currently a senior adviser to, the Islamic Finance Section of the American Bar Association. He has also served as a Lecturer in Islamic Finance at the University of Pennsylvania Law School and the Wharton School of Business.

Mr McMillen has worked in the Islamic finance field since 1996 and in the field of project finance since 1983. He has twice been a recipient of the award for Best Legal Advisor in Islamic Finance by Euromoney Magazine. He has also been the recipient of the Sheikh Mohammed bin Rashid Al-Maktoum award as Best Legal Advisor in Islamic Finance in North America. He has authored more than 50 articles on Islamic finance, including in leading law journals such as the Chicago Journal of International Law, the Capital Market Journal published by Oxford University, the Fordham International Law Journal, and the Wisconsin Journal of International Law. He also speaks extensively on different topics in the fields of Islamic finance and project finance.

Dr Mohammed Al-Sheaibi is Head of the Legal Department at the Saudi Arabian Monetary Agency (SAMA). He graduated from Duke University, North Carolina, in the United States and received his Master of Law (LLM) in 1990 and PhD in Juridical Science (SJD) in 1993. Dr Al-Sheaibi is responsible for advising the senior executives in SAMA on legal issues such as banking laws, securities laws and corporate laws. He has previously held several positions in SAMA, such as Senior Counselor at the Banking Control Department, Legal Adviser in the Shares Control Department, and with the Committee for Banking Disputes.

Dato’ Dr Nik Ramlah Nik Mahmood is Managing Director of Securities Commission Malaysia (SC). She is also Executive Director of the SC’s Enforcement Division and a Director of the Securities Industry Development Corporation (SIDC), the training and education arm of the SC. She is very actively involved in work relating to the development of the Islamic capital market. She provides strategic and policy input on matters relating to the development of Malaysia's Islamic capital market and supervises the implementation of the recommendations of the Capital Market Master plan in relation to the Islamic capital market.
Dato’ Dr Nik Ramlah is also involved in many of the SC’s other developmental initiatives for the Malaysian capital market, such as the development of the bond market, venture capital industry, fund management, corporate governance and rationalisation of the regulatory framework. She is a member of the Professional Development Panel of the International Centre for Education in Islamic Finance (INCEIF) and the global University of Islamic Finance, and is a practising member of the Association of Chartered Islamic Finance Professionals Malaysia (ACIFP). She is also a member of the Technical Committee of the Islamic Financial Services Board (IFSB).

Dato’ Dr Nik Ramlah obtained a First Class Honours in Law from the University of Malaya, as well as an LLM and PhD from the University of London. For her PhD, she was a recipient of a scholarship from the Association of Commonwealth Universities. Prior to joining the Securities Commission in 1993, Nik Ramlah was an Associate Professor in the Faculty of Law, University of Malaya. In 2007, she was named “Most Outstanding Person for Contribution to Islamic Finance” by the Kuala Lumpur Islamic Finance Forum (KLIFF).

Ms Sau Ngan Wong is a Senior Counsel in the Finance, Private Sector and Infrastructure practice group within the Legal Vice Presidency of the World Bank. Her expertise is in the area of financial regulation and capital markets. She has participated in a wide range of financial sector policy and legal advisory work in the areas of bank restructuring and consolidation; financial sector assessment programs; assessment on consumer protection framework for the financial sector and policy advice in relation to the capital markets including the securities, pensions and insurance sectors. She is a member of the World Bank’s Islamic Finance Working Group.

Before joining the World Bank, Sau Ngan Wong was General Counsel for the Securities Commission of Malaysia during which she was responsible for providing strategic and legal advice on all matters relating to capital market policies and fund raising framework. She has led and directed several major regulatory and legislative reforms in the Malaysian capital market including the consolidation and modernisation of the Capital Markets & Services Act 2006 that lays the foundation for a sound and robust investor protection framework; the establishment of appropriate audit oversight and corporate governance for listed entities; revamping the equity fund raising framework and led the strategic enforcement initiative. Prior to 2006, she served as Head of Policy Review and Formulation from 1998 to 2002 and Specialist in the Market Policy and Development Division from 2003 to 2006. In these capacities, she led various institutional and regulatory reforms for the capital market to restore market confidence as well as leading the development of the corporate bond market in Malaysia. She has participated in a variety of regional work including the Asian Bond Market Initiative as well as the ASEAN market integration project. Overall, she has 30 years experience in financial regulation with 14 years in the Central Bank of Malaysia and 16 years in the Securities Commission of Malaysia.

Sau Ngan Wong has a Master of Law degree from the Harvard Law School and a Bachelor of Laws with Honours from University of Malaya, Malaysia. She was admitted to the Malaysian Bar Council to practise as an advocate and solicitor in 1981. She is co-author of Law, Institutions and Malaysian Economic Development (Singapore: NUS Press, 2008), co-wrote the chapter titled "Islamic Exchanges: Principles & International Developments” in Exchanges & Markets (Oxford University Press, 2006) and was country contributor in The Role of Law and Legal Institutions in Asian Economic Development 1960 – 1995 (Oxford University Press, 1999).
Dr. Tunc Tahsin Uyanik is Sector Manager of the Financial and Private Sector Development Programme in East Asia and Pacific Region. In this capacity, he is responsible for directing and implementing the strategy for financial and private sector development work of the World Bank for the East Asia and Pacific Region (EAP) and leads development-related policy dialogue with the Governments in the financial and private sectors in EAP.

Prior to his appointment as the Sector Manager of the Financial and Private Sector of East Asia and Pacific Region, Dr. Uyanik held the position of Sector Manager, Financial and Private Sector Development in Europe and Central Asia Region (ECA) with the World Bank Group. He had led various operations in the ECA region including banking sector restructuring, bank liquidation and privatisation; bank restructuring, asset recovery, management, and liquidation; capital market development; lines of credit and guarantees in Albania, Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, Macedonia, Romania, Russian Federation, Tajikistan, Turkey, Uzbekistan and EU accession countries. In addition, he led the World Bank teams during the implementation of Financial Sector Assessment Programmes for Kyrgyz Republic and the Russian Federation.

Dr. Uyanik is currently leading the World Bank Group’s efforts on Islamic finance in terms of coordinating the analytical and operational work within the Bank. He sits on various working groups of the IFSB and AAOFI in a number of Islamic finance development issues. Prior to joining the World Bank, Dr. Uyanik worked in managerial and advisory positions in various Turkish banks. He was also an Associate Professor of Finance and Accounting at Hacettepe University, Turkey.

Mr Wan Abdul Rahim Kamil currently serves as an Islamic Capital Market consultant with the Securities Commission Malaysia (SC). He advises on, and helps formulate and develop, the regulatory as well as market framework for the Islamic capital market industry in Malaysia. He was also involved in similar tasks with respect to the Islamic banking during his time with Bank Islam Malaysia Berhad.

Throughout his three decades’ involvement in Islamic finance, he has been personally credited with developing several of the Islamic finance innovations introduced in the market, such as Rahnu (for Islamic pawnshops), Murubahah Notes Issuance Facility (MuNIF) commercial papers, Islamic bonds issued under the contracts of Musharakah, Qard al Hassan and Bay‘ Bithamin Ajil (BAIDS), and the first Islamic asset-backed securities.

Mr Wan Abdul Rahim is a regular contributor to Islamic Banker, an internationally distributed monthly publication on Islamic finance. He holds a Professional Membership from the Institute of Statisticians (now merged with the Royal Statistical Society) of the UK. He also holds a post-graduate degree from the International Institute of Islamic Banking and Economics, Republic of Northern Cyprus.
OPENING REMARKS TO THE ROUNDTABLE DISCUSSION

THE IFSB - WORLD BANK ROUNDTABLE DISCUSSION ON INSOLVENCY
REGIMES: INSTITUTIONAL, REGULATORY, AND LEGAL ISSUES RELATING TO
ISLAMIC FINANCE

James Adams¹

Excellencies, distinguished guests, ladies and gentlemen,

I would like to express my sincere gratitude to the Islamic Financial Services
Board and the World Bank team for organising this important roundtable event. We
have a very diverse group of experts here today and the structure of this event is an
excellent way to promote cross-country learning on experiences with insolvency
regimes for Islamic finance.

I appreciate the opportunity to open this discussion. I want to start by
emphasising how important the Islamic finance issues are emerging in the World Bank.
We now have a very active Islamic Finance Working Group within the Bank. And I think
what you are going to see from the World Bank is not just a willingness to focus on
broad development issues in relation to Islamic finance but also a willingness, as today,
to focus on specific issues such as the regulatory and legal challenges in relation to
insolvency regimes and willingness for us to learn from key actors who are working in
this area throughout the world.

Everyone in this room acknowledges Islamic finance as an important segment
in the financial sector. The industry has been growing at a rapid pace, even in the face
of the most devastating financial crisis the world has seen since the 1930s. In fact,
some market studies suggest that the Islamic banks could account for up to 40 to 50
percent of total deposits in a few countries with majority Muslim populations. Given that
many of the World Bank’s client countries fit this description, we see Islamic finance as
an important industry for promoting financial stability and expanding access to finance.

The global financial crisis has generated a lot of interest in Islamic finance as a
form of financial intermediation that can promote financial stability. This is due to the
Sharī‘ah principles directly linking financial activities and the real sector, the prohibition
of speculation and interest-based structures, and the application of high ethical
standards in business conduct.

Studies have shown that the Islamic financial industry has been relatively
resilient during the current crisis because of these requirements. However, the industry
has not been fully shielded from the storm. Several Islamic financial services providers
and instruments were threatened with failure, and indeed some Islamic bonds, or
Sukūk, defaulted as a result of the second round effects of the global financial crisis. In
the event of default by a borrower, there is currently insufficient clarity and certainty of
their claims against the borrower. The uncertainty on the claims on the underlying
assets of Islamic financial products, and differences in interpretation across
jurisdictions on Sharī‘ah compliance, can potentially complicate resolution procedures
and jeopardise creditors’ confidence in Islamic financial services providers and
products.

¹ Mr. James Adams, is Vice President for East Asia and Pacific Region, at The World Bank
In addition, there are no specific guidelines on the resolution regime for Islamic banks in the event of insolvency. Therefore, the immediate challenge before us is to establish a coherent system of insolvency rules and principles which are consistent with the philosophy of Shari’ah and benchmarked against international best practices.

This is indeed a very difficult and complex area of regulation, regardless of whether it is on a conventional or Islamic basis. In the conventional realm of finance, there is much uniformity of banking law and regulations governing the legal status, organisation and prudential regulation of banks. However, there is much less agreement on approaches to bank insolvencies. Unlike insolvency laws that apply to commercial entities that can take effect after insolvency has been declared, bank regulators often have the authority to commence corrective actions against a bank that the regulators have declared as insolvent. The bank regulator may even take appropriate corrective actions when the bank fails to meet certain prudential requirements even if the bank is solvent.

Bank restructuring or rehabilitation is part of a continuum, ranging from enforcement of prudential regulations to receivership. An equally important consideration for bank insolvency is the need for prompt and timely action to contain the effects of a potential systemic crisis. Given the importance of effective insolvency regimes, the World Bank has been engaged in the development of standards for insolvency for many years. The Bank’s Principles for Effective Insolvency and Creditor Rights System were developed in 2001 in response to requests from the international community in the aftermath of the Asian financial crisis. These Principles were created to identify internationally recognised best practices in the design of insolvency laws and the due protection of creditor rights.

More recently, the World Bank and IMF published a paper in April 2009 on the legal, institutional and regulatory framework that countries should put in place to address cases of bank insolvency. However, it does not deal with Islamic bank insolvencies or with insolvency issues relating to Islamic financial instruments. Therefore, we are now actively engaged with the IFSB on understanding the issues and problems relating to resolution regimes for institutions offering Islamic financial services and developing appropriate approaches for effective resolution frameworks. We are working together to develop an analytical assessment that will aim to be the foundation for new international standards for insolvency of Islamic financial institutions. Some of the key areas the teams will be looking at include possible defaults which could trigger risks of insolvency, the rights and obligations of parties, and the recourse to assets that are pledged in the relevant transactions. The work will also highlight prudential issues that may arise during insolvency proceedings of Islamic institutions. It will recommend approaches in the design of insolvency principles which can support harmonisation of insolvency regimes for Islamic institutions and international best practices, as well as outline the policy implications, principles and conditions for their restructuring. All of the input and insights shared during this roundtable will inform this work.

The World Bank has already become deeply involved in the Islamic financial sector, focusing first on the international standards for the industry as they are areas where we can have the most impact. The area of insolvency is a strong example of this. Although the World Bank has already committed substantial resources to this important area of work, we have developed a comprehensive proposal for an Islamic Multi-Donor Trust Fund to support the implementation of this work and other work in the area of Islamic finance. The proposal aims to pool donor funding in one location and develop economies of scale in the provision of technical assistance. The core focus of this Trust Fund would be on: financial stability, access to finance, financial
markets and industry standards. In addition, we already have a robust pipeline of projects for the next three years that would benefit from the backing of such a Trust Fund. We would welcome further discussions of this concept with many of you in this room today.

I want to thank all of you very much for your participation in this exciting event on a critical topic to the development of the Islamic finance industry. This Roundtable is a great opportunity for everyone to share experiences on all issues relating to insolvency of institutions offering Islamic financial services. It is also an excellent venue to share practical approaches to effective resolution regime to maintain financial stability and maintain creditors’ confidence.

I wish you all a productive morning of discussions.

*October 10, 2010*
*Washington D.C.*
CHAPTER ONE

ISSUES PAPER

ISLAMIC FINANCE TRANSACTIONS AND THE IMPACT OF INSOLVENCY

By Hamid Yunis
CHAPTER ONE: ISSUES PAPER

ISLAMIC FINANCE TRANSACTIONS AND THE IMPACT OF INSOLVENCY

Hamid Yunis

I. Introduction

*The Lawful is self evident and the Unlawful is self evident.... Yet between the two, are matters that may give rise to confusion, not well understood by many people.* – The Prophet Muhammad (peace be upon him)

This Hadith can be seen to set out guidance for creating a foundation for the legal system of Islam, its jurisprudence and, indeed, practical implications. However, in addition to this Hadith, the other factors that determine how Shari‘ah is to apply include a consideration of both the physical form (Jasad) and the spiritual form, consisting of intelligence (al ‘Aql), instinct (al-Ghara‘is), emotion (al-Infi‘alat), sentiment (al-Awatif) and desire (al-Muyur). Intelligence, or ‘Aql, is viewed as not being sufficiently developed to guide and control the rest of the spiritual form in order to ensure that the physical form is protected. Accordingly, there arises the need for a framework or infrastructure to create the necessary governance.

In an increasingly complex commercial world where we are seeing the frequent use of Islamic finance in both Shari‘ah-compliant and conventional jurisdictions, the Hadith stated above (and its related elements) is even more important. It also has to be acknowledged that secular (or conventional) legal systems have established rules to deal with a variety of commercial situations; however, it is interesting to see how these rules interact with transactions that have been structured in a Shari‘ah-compliant way. Inevitably, a consequence of such interaction – and possibly a benefit – is that Shari‘ah-compliant transactions are stress tested against such rules.

Specific to insolvency, from a Shari‘ah perspective it can be seen as the incapacity to meet obligations, which suggests remedies from an ethical perspective:

“If the debtor is in a difficulty, grant him time till it is easy for him to repay. But if you remit it by way of charity, that is best for you if you only knew.” (Surah al-Baqarah, V: 280)

However, there are additional considerations with regards to the types of insolvency, such as:

- *Iflas* – which essentially is a form of bankruptcy and, in a practical sense, can cover balance sheet insolvency (i.e. the simple test of where assets are insufficient to cover liabilities) and income or cash-flow difficulties (i.e. insufficient liquidity to pay debts as they fall due); and

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• *Muflis* – the actual entity (which includes both a person and a business entity) is in a state of difficulty. Under the Shari’ah, there is no specific distinction made between a business bankruptcy and an individual bankruptcy. There are, of course, other complications in that the Shari’ah does not recognise entities that limit personal liability, which in itself causes complexity when there is an interface with conventional insolvency systems.

One of the key commercial scenarios that any legal system has to deal with is the insolvency of an enterprise. Shari’ah-compliant structures, which have been designed to comply with the Shari’ah, are not immune from insolvency.

In this chapter, we focus, in particular, on the way insolvency issues affect Shari’ah-compliant transactions. We will endeavour to highlight the following:

• the issues surrounding the recognition of Shari’ah by courts in a conventional legal system – in particular, the United Kingdom;

• contractual techniques commonly used in Islamic finance and which need to be taken into account when considering specific insolvency arrangements; and

• discussions on the issues that would arise on an insolvency, including insolvency of an Islamic bank.

**II. Recognition and Enforcement of Shari’ah**

Issues dealing with the recognition of Shari’ah on a legal basis will, by definition, arise only in secular legal systems or jurisdictions where courts do not, on the face of it, recognise Shari’ah. They will have to interpret Shari’ah-compliant transactions in the context of applying the established rules of that particular jurisdiction.

**A. Shamil Bank v Beximco**

The English court decision in *Shamil Bank v Beximco* ([2004] 4 All ER 1072) was key in illustrating the problems courts can face in such circumstances and their attempts at resolving such issues. The facts of the case were as follows:

• In 1995, two companies in the Beximco group of companies (the "Beximco Companies") executed a Murābahah Agreement (the “1995 Agreement”) with Shamil Bank pursuant to which Shamil Bank advanced funds to the Beximco Companies for the purchase of certain goods.

• The 1995 Agreement was guaranteed by two directors of the Beximco Companies and by the parent company of the Beximco Companies as the combined “Guarantors”.

• A number of scheduled payments were made under the 1995 Agreement by one of the Beximco Companies.

• In 1996, the Beximco Companies entered into a second Murābahah Agreement (the “1996 Agreement”) with Shamil Bank pursuant to which further funds were advanced. The second of the Beximco Companies
made various payments pursuant to this agreement in accordance with its terms.

- Subsequently, both Beximco Companies were in default of the 1995 Agreement and the 1996 Agreement (together the “Murābahah Agreements”).

- Over the course of the next few years, the Beximco Companies entered into Ijārah agreements (the "Ijārah Agreements") pursuant to which certain assets of the Beximco Companies were transferred to Shamil Bank in satisfaction of (and in support of) the Murābahah Agreements.

- The Beximco Companies were also given the right to use the transferred assets in return for which they agreed to make payments to Shamil Bank in respect of such use.

- Each of these Ijārah Agreements was also guaranteed by the guarantors.

- It is not clear from the reported judgment whether the Shari’ah supervisory board of Shamil Bank reviewed the precise transactions and related documentation for the Murābahah Agreements and the Ijārah Agreements.

- By the middle of 2002, both the Beximco Companies were in default of the Ijārah Agreements and Shamil Bank provided notices of default and made claims in excess of US$49 million on the Ijārah Agreements and the guarantees provided by the Guarantors.

- The governing law provision of the Ijārah Agreements provided that “Subject to the Glorious Shari’ah, this Agreement shall be governed by and construed in accordance with the law of England”. The governing law provision of the guarantees made no reference to Shari’ah.

The court of first instance awarded judgment to Shamil Bank for approximately US$49.7 million. However, in reaching this decision, it determined that it was not necessary to concern itself with principles of Shari’ah.

1) Judgment (on Appeal)

The Court of Appeal held that:

“a number of defences were advanced by the defendants before the judge below, certain of which were regarded by the judge as having the hallmarks of trumped-up defences designed to avoid or delay payment. However, the principal defence advanced was that, (a) on a true construction of the governing law clause…. the Murābahah agreements and the Exchange in Satisfaction and User Agreement (ESUAs) were only enforceable in so far as they were valid and enforceable both (i) in accordance with the principles of the Shari’ah… and (ii) in accordance with English law; (b) in fact the agreements were unlawful, invalid and unenforceable under the principles of Shari’ah in that, despite their form as Murābahah agreements, in the case of the 1995 and 1996 Agreements, and as Ijārah leases… the transactions were in truth disguised loans at interest. As such they amounted to unlawful agreements to pay Riba and were thus void and/or unenforceable.”
The Court of Appeal held that the *Ijārah* Agreements were governed by English law alone. The intention of the parties from the outset had been for the agreements to be binding and the court should not follow a construction which would or might defeat the commercial purpose.

The reference to the principles of *Sharī'ah* was simply intended to reflect the Islamic banking principles according to which Shamil Bank held itself out as doing business, rather than incorporating a system of law intended to usurp the application of English law as the law to be applied in ascertaining the liability of the parties. Having chosen English law as the governing law, it would have been unusual and improbable for the parties to have intended the English court to proceed to determine and apply the principles of *Sharī'ah* in relation to the legality and enforceability of the obligations.

The Court of Appeal also acknowledged that the foregoing was of no assistance to the Beximco Companies, acknowledging the application of the principle that the governing law of a contract may be that of one nation, while incorporated contractual terms may come from another body of law or rules. However, such an incorporation concept is only workable where the parties have by the terms of their contract sufficiently identified specific black letter provisions of a foreign law or an international code or set of rules to be incorporated as terms of the relevant contract such as a particular article or articles of the French Civil Code. By that method, English law is applied as the governing law to a contract into which the foreign rules have been incorporated. The Court of Appeal also held that the generality of the incorporation of the contractual terms, if any, pursuant to the phrase “subject to the Glorious *Sharī'ah*” was insufficient to identify specific and identifiable "black letter" provisions of the *Sharī'ah* and thus ineffective.

As will have been noted from the above, short of identifying specific *Sharī'ah* rules and almost incorporating them in like provisions in a contract, an English court would interpret a contract before it under its governing law which would have to be the law of a nation or indeed a clearly identifiable set of rules or regulations. Nevertheless, such an incorporation of *Sharī'ah* rules would still be subject to certain limitations, such as those relating to the public policy of the jurisdiction (in which the court is based).

Notwithstanding the *Beximco* judgment and the apparent stance of the UK courts, which seems to be fairly clear and unambiguous, an English court has upheld an arbitration award based on the application of *Sharī'ah* (as it applied in those circumstances): *Sayyed Mohammed Musawi v R.E. International (UK) Limited & Others* [2007] EWHC 2981 (CH).

### B. Symphony Gems Case

In this case, an Islamic company entered a *Murābahah* agreement to provide precious gems to Symphony Gems (SG). The issue in dispute was the amount of the balance due. Both parties agreed that:

> “this agreement and each purchase agreement shall be governed by, and shall be constructed with, English law… the courts of England shall have exclusive jurisdiction to hear and determine any suit…”

However, provision was also made for the following:

> “the purchaser wishes to deal with the seller for the purpose of purchasing supplies under this agreement in accordance with the Islamic *Sharī'ah*.”
The court considered three aspects. These were:

- **Murābahah and the risk of a failure to deliver.** It was argued by the non-payer that its default was due to an alleged delivery failure by the supplier (i.e. the seller only gets the goods when they have reached their destination). According to Murābahah, the risk of failure to deliver should be borne by the financier, as sharing this risk justifies the profit.

However, the judge did not consider the application of Shari‘ah in his decision. The agreement was viewed as a typical trade financing transaction where the risk of failure to deliver was apportioned to the purchaser. The judge’s interpretation was supported by the contract, which stated that the payment by the purchaser, SG, should take place “in all cases notwithstanding any defect, deficiency or any loss or any breach of any supply contract … by the supplier” and stated that “such payment will not be conditional upon the happening of any event”.

The judge said in his decision

“It is a contract governed by English law. I must simply construe it according to its terms as an English law contract.”

Had the judge considered the application of Shari‘ah, the court would not have accepted the above terms in releasing the bank from its responsibility under Murābahah.

- **The illegality of the transaction.** SG argued that the contract was against the Shari‘ah. The court refused to accept the illegality defence, for two reasons:
  - English law had been chosen to govern the agreement without any restrictions or limitation; and
  - The agreement was not to be applied in part in a country where Shari‘ah was the law of the land.

- **The application of the ultra vires doctrine.** The Murābahah contract included the following condition: “Payment will not be conditional upon the happening of any event.”

Essentially, this said that the payment to the bank was guaranteed, no matter what – which explicitly contradicts Shari‘ah law principles, which require parties to share risk in order to gain profit. The court found that the application of the ultra vires doctrine could impact upon the interests of international commerce in that parties could abuse this doctrine to avoid their contractual responsibilities. It must be noted that the English court has always been reluctant to apply the ultra vires doctrine. It has been considered a “technical” rule that could undermine the position of London as a leading centre for international financial markets.

Given this backdrop of what is capable of being enforced in a conventional legal system, we will now consider how insolvency impacts on the most commonly used Islamic finance structures.
III. Islamic Finance Structures

In modern-day practice, and as practitioners have generally acknowledged, Islamic finance essentially involves the use of certain contractual, investment and financing structures which can have similarities to conventional structures. In such a market where there are similarities with conventional structures, the recognised rules of contract will apply.

On a general level, the key contractual structures used in Islamic finance, and which are of relevance to this chapter, are as follows:

- **Murābahah**: This is generally described as a cost-plus financing structure. A transaction could involve one party making a purchase of an asset at the request of another and then selling the asset back to that other party on a deferred sale basis with a profit mark-up. The profit mark-up is determined before the purchase takes place and cannot usually be modified during the life of the contract. Notwithstanding the above, the deferred consideration may be paid on scheduled repayment dates plus the mark-up over the term of the contract.

- **Ijārah**: These are essentially leasing arrangements that are comparable to conventional operating and finance leases. By way of example, a financier may rent an asset to its client for an agreed and scheduled repayment over a period of time, but the client does not normally have the option of owning the asset. However, agreed option arrangements may be entered into by the parties to give the client the option of owning the asset during or at the end of the term.

- **Istīnsā':** This operates like a commissioned manufacture and is commonly used on construction or real estate development projects. The financier is responsible for manufacturing assets or constructing property, usually through a parallel contract with a third-party entity that actually performs the required service. The financier then sells the asset to the client at a profit, which is its mark-up or profit, in exchange for taking on the risk of manufacture construction. **Istīnsā'** also operates like a cash sales contract made against a promised future delivery of goods. Interim or progress payments may be made to the financier during the manufacturing/construction process.

- **Muḍārabah**: This is similar to an equity arrangement. It is also similar to conventional limited partnerships, where one party contributes capital to a business and the other party provides expertise or management. A profit-sharing ratio is usually agreed prior to undertaking the project.

- **Mushārakah**: This is similar to an equity arrangement and can be compared to a joint venture in that two parties provide capital towards the financing of a particular project. Profits are shared based on a prearranged ratio, but losses are allocated in proportion to equity participation.

- **Sukūk**: These are frequently referred to as Islamic bonds or, more accurately, Islamic investment certificates and have been used widely in the last few years – in particular, for sovereign/government fund-raising, treasury instruments for financial institutions and by corporates. A **Sukūk** is different from a conventional bond, which essentially represents a contractual debt obligation. Under a **Sukūk** structure, the **Sukūk** holders (or certificate holders) hold an undivided beneficial ownership in the underlying assets. **Sukūk** holders (or certificate holders) are
also entitled to share in the revenues generated by the Sukūk assets, as well as being entitled to share in the proceeds of the realisation of the Sukūk assets.

In addition to the above, the contractual forms can be categorised as follows:

- **Contract of exchanges** (‘Uqud al Mu’awadhat – i.e. Murābahah, lījārah, Istinā”). The transaction involves a deferred payment or delivery terms, and the contractual relationship between the two counterparties is similar to one of debtor and creditor.

- **Contract of participation or investment** (‘Uqud al Ishtirāq). The contract is used for funding or investment, and the relationship between the counterparties is either one of co-investors or investor/entrepreneur/implementer.

The categorisation above has specific roles when it has to deal with insolvency. Other forms of Islamic finance structures include Urbūn, Salām and, indeed, derivative or hybrid structures based on the above. Additionally, for the purposes of this chapter, we have not dealt with the substantial subject of Takāful (and its related aspects), which is a form of Shari’ah-compliant insurance.

**IV. A General Overview of Insolvency Issues in Islamic Finance**

Islamic finance gives rise to certain insolvency issues and, in theory, some of these issues are addressed and hopefully resolved by Shari’ah-compliant legal systems such as those found in Saudi Arabia, Sudan and Pakistan. In this section, we consider the obvious questions that arise for insolvency practitioners, financiers and other professionals involved in the Islamic finance industry. In particular, we consider where Shari’ah-compliant elements of a transaction converge with those which are structured conventionally or on a mainstream basis.

A number of examples from some Middle Eastern jurisdictions also complicate the position further. It is clear that some Shari’ah principles are superseded by a more conventional way of thinking or, indeed, by secular laws. For instance:

- Sale of assets on default may require a court order; and

- Termination of an lījārah lease may be affected by contractual provisions/secular notice provisions which are built into the documentation which, in its drafting, has replicated more conventional leasing documentation.

**A. Specific Country Examples**

Below are examples of how the issues addressed above exist in the legal and regulatory frameworks of some countries:

1) **Emirate of Sharjah (Law No. 17/1973)**

Under Article 33, which essentially deals with mortgaging of real estate, to enforce a mortgage or security over real estate, the person who is owed money (the “Creditor”) must apply to the Land Department. The Land Department must also notify the alleged defaulting party (the “Debtor”) that they have a period of time to pay the underlying debt.
However, the Debtor can ask for any enforcement action to be postponed for a period of time (usually up to one year) if they can show an ability to pay but require time. They can also argue that the enforcement action may cause undue hardship.

2) Kuwait (Article 231 of Law No. 68/1980 (Commercial Transactions Law))

A mortgagee has to wait a period of time (three days) from non-payment of a debt before applying to the court for enforcement. If enforcement is through a sale and the court so orders, the mortgagee must notify the mortgagor and wait a period of time (five days) before the enforcement can be executed.

3) Malaysia

There has been some recent commentary in connection with defaults under Murābahah contracts. Questions have arisen as to whether the whole deferred price is due, or just a reduced amount to reflect the early payment so as not to over-benefit the person owed the money.

Mixed messages have been given by the courts. However, the ultimate guidance to the courts is to refer Shari'ah questions to the Supreme Shari'ah Committee at the Central Bank of Malaysia, with its decision on such questions then being binding on the courts.

4) Abu Dhabi

In Abu Dhabi, a court judgment held, by looking at the substance of the contract rather than the form, that a Mushārakah financing was essentially a loan.

B. Additional Issues

Awareness of the rapidly developing Islamic finance market may ultimately smooth out some of the discrepancies that remain outstanding. However, there are still several general and policy issues for conventional banks and, in particular, for insolvency practitioners in conventional legal systems that may arise in Islamic finance transactions.

1) Matter over Arrangement

In Ijārah structures, there is a concern as to whether the financier's retention of title over the asset will be the "superior" and overriding interest in situations of insolvency. Often, property and security laws apply and regulate transactions that create security interests.

For example, there is a risk that a retention of title clause could be re-characterised by the courts as a clause creating actual security which may require registration, pursuant to local law regulations, to actually be enforceable.

2) Form/Functional Approach

The fundamental divide between various jurisdictional approaches to the status of security is the form versus functional approach.

The form approach dictates that the grant of security is different from retention of title under conditional sale or other leasing arrangements in that the conditional buyer or a lessee has merely a possessory interest, and the seller or lessor enjoys absolute ownership by virtue of the agreement between the parties.
The *functional approach*, on the other hand, treats a conditional buyer or lessee with an option to purchase as the owner of the property; the interest of the conditional seller or lessor is limited to that of a security interest, so that the reservation of title clauses in such agreements between the sellers and lessors and conditional buyers or lessees are treated much like chattel mortgages, or, in the case of property, real property mortgages.

Professor Roy Goode, in his book *Legal Problems of Credit and Security*, states that:

“...the functional approach is that adopted throughout the United States under Article 9 of the Uniform Commercial Code, throughout Canada under its Personal Property Security Acts based on Article 9 and in New Zealand under its Personal Property Security Act 1999. The legal systems of other countries including the United Kingdom, and legal systems belonging to the common law family outside North America and New Zealand and to a civil law family, adhere to the formal approach.”

**Form and substance**

Some jurisdictions will look at the form of the transaction together with its substance. For example, if the documents that have been drafted to record the agreement between the owner/seller and the conditional buyer/lessee are in reality a sham used to disguise the true nature of the agreement reached between the parties, the court will look behind the document to ascertain its real legal nature.

One example of this is the reference above to an Abu Dhabi court judgment, where the court looked at the form of a *Mushārakah* but constructed it as being essentially a loan. The nature of rights intended to be conferred by the parties is to be determined from the terms of the agreement reached by the parties, and a characterisation of such rights is a matter of law to be determined by a court. The court may have regard to the legal substance of the parties’ agreement, rather than the economic effect.

Under English law, where title has clearly been retained by the seller and there is no question of transfer of ownership, the courts will not re-characterise such retention of title clauses as creating security interests that would fail in the insolvency of the buyer/lessee for lack of registration.

However, this requires accurate drafting, and care must be taken to ensure that no ownership rights are transferred to the buyer/lessee until strict conditions for the ownership or the transfer of such ownership have been met. There is nothing objectionable under English law to conditional sale or hire purchase, so long as the parties clearly record this in their contracts.

For an "extended retention of title" clause to be effective, it is necessary for the clause to establish a fiduciary relationship between the seller and purchaser, where the purchaser holds the goods on trust for the seller. The purchaser must be required to store the goods in such a way that they are clearly identifiable as the property of the seller; the purchaser must not be able to use the receivables generated from the sale of goods in the ordinary course of its business; and there must be an obligation on the purchaser to keep the receivables generated from the sale in a separate account. As a result, "extended retention of title" is usually not problematic in England.
In summary, on the form or substance debate, so long as Islamic finance transactions adequately draft the split between ownership and possession and are not designed basically to disguise the true nature of the transaction, we do not see such transactions as problematic in jurisdictions that adhere to the formal approach.

3) The Financier as Landlord

In traditional mortgage financings, financiers who take a legal charge over a property ensure that adequate provisions are built into the security documents in order to prevent them becoming "mortgagees in possession", at least until specific conditions have been met.

However, under Murābahah real estate transactions, there is a risk that an insolvent debtor may disclaim the unexpired portion of the Murābahah arrangement and thereby argue that all possession and control of the property lies with the financer as landlord.

This would impose additional obligations on the financer as landlord and needs careful drafting to counteract the position.

4) The Financier in Control

Normally, financiers take special care to avoid any action that may be construed or deemed to be the financier taking control of the borrower (or its management).

In Mudārakah structures and Mushārakah transactions, this may be difficult to achieve unless careful thought is given to the drafting of applicable contracts.

If a financier is found to be controlling a company that becomes insolvent, it might lead to significant implications. For instance, section 214 of the Insolvency Act 1986 provides as follows:

214. Wrongful trading

1. Subject to subsection (3) below, if in the course of the winding up of a company it appears that subsection (2) of this section applies in relation to a person who is or has been a director of the company, the court, on the application of the liquidator, may declare that that person is to be liable to make such contribution (if any) to the company's assets as the court thinks proper.

2. This subsection applies in relation to a person if:
   a) The company has gone into insolvent liquidation,
   b) At some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and
   c) That person was a director of the company at that time;

   but the court shall not make a declaration under this section in any case where the time mentioned in paragraph (b) above was before 28th April 1986.

3. The court shall not make a declaration under this section with respect to any person if it is satisfied that after the condition specified in subsection (2)(b) was first satisfied in relation to him that person took every step with a view to minimising the potential loss to the company's creditors as (assuming him to
have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation) he ought to have taken.

4. For the purposes of subsections (2) and (3), the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by a reasonably diligent person having both:

   o The general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and

   o The general knowledge, skill and experience that that director has.

5. The reference in subsection (4) to the functions carried out in relation to a company by a director of the company includes any functions which he does not carry out but which have been entrusted to him.

6. For the purposes of this section a company goes into insolvent liquidation if it goes into liquidation at a time when its assets are insufficient for the payment of its debts and other liabilities and the expenses of the winding up.

7. In this section "director" includes a shadow director.

8. This section is without prejudice to section 213.

"Section 214 does not only apply to de jure directors of the company, but also to de facto or shadow directors. A bank exercising control for the protection of its loan and security is capable of being a shadow director.

Guidance on trying to avoid creating a "shadow directorship"

If a financier does find itself in a position where it might be deemed to be a shadow director, it would be useful for it to keep in mind Professor Roy Goode’s 12 points for survival listed in his book Principles of Corporate Insolvency Law and set out below:

- Do not assume that the safest course is to stop trading. You have to take every step that can properly be expected of you to minimise loss to creditors. You can be faulted just as much for a premature cessation of trading as for continuing to trade while insolvent. This makes it essential to obtain competent outside advice as to whether to stop trading or continue.

- Consider carefully with your fellow directors whether the business is viable. If it is, insist on the preparation of:
  - A business review;
  - A sensible and constructive programme to reduce expenditure, increase income, ensure an adequate cash flow and restore the company to profitable trading, disposing of unprofitable or marginal parts of the business and dismissing staff who are surplus to the company's needs or are not doing their job.

- Insist on frequent board meetings.
Make sure that there is a proper distribution of responsibility within the company.

Ensure that the accounts are being properly kept and up to date or if not, that prompt steps are being taken to do so, with outside help being brought in as and when necessary.

See that the board regularly receives an updated budget and a full, accurate and up-to-date picture of the company’s trading, financial and cash flow position.

Get the company to take appropriate outside professional advice on suitable remedial measures.

Keep major creditors regularly informed and enlist their support for the continued operation of the company where this is likely to be of benefit to the general body of creditors. In this connection it is just as important to have the support of major unsecured creditors as of secured creditors, for it is the former who are most likely to suffer loss and whose support makes it easier for you to show subsequently that you took every step available to you to minimise loss to creditors.

Ensure that you are kept fully in the picture and, so far as possible, that all directors agree on what needs to be done.

Consider the advisability of putting the company into administration in order to give it breathing space and prevent action by individual creditors. Such appointment has the further advantage of ending your management responsibilities, though you still have a duty to co-operate with the office-holder.

Insist that all recommendations for remedial action made by the directors (and particularly by you), together with your dissent from any unwise actions or inactivity advocated by your fellow directors, are fully-minuted or otherwise placed on record, e.g. by the circulation of a memorandum to the other directors.

If you are in the minority and your recommendations are repeatedly rejected, so that the company is getting deeper into the mire, resign and record your reasons for doing so in a letter. But resignation is very much the last resort. A director who simply resigns without having taken every step he should have done to minimise loss to creditors will not escape liability. So don't resign before you have gone as far as you can in getting things put right."

Apart from the wrongful trading provisions referred to above and similar provisions appearing in other jurisdictions, more stringent criminal liabilities may be imposed on directors of a company for fraudulent trading which do not necessarily depend on the company being wound up. In the UK, under section 213 of the Insolvency Act 1986, during the winding up of a company, if it appears that any business of the company has been carried on with the intent to defraud creditors of the company or creditors of any other person, then the court may on an application of the liquidator declare that any persons who were knowingly involved in the fraudulent trading will be liable to make contributions to the company’s assets as the court thinks appropriate.
Jurisdictions with established insolvency rules that have not been tailored to insolvency issues in an Islamic finance context will undoubtedly lead financiers in such jurisdictions to mitigate such risks through carefully constructed contracts, the use of corporate structures and, possibly, various forms of insurance or indemnities. However, even such structuring or "ring-fencing" is not completely immune when the greater interests of creditors at large or other stakeholders are affected.

5) Insolvency Remoteness in Sukūk Transactions

In Sukūk transactions, it is important to ensure the insolvency remoteness of the special purpose vehicle (SPV) issuer. For instance, in the event of the bankruptcy of the issuer, the assets could be distributed in accordance with the applicable law, rather than the relevant contractual arrangements within the original Sukūk structural arrangements.

Furthermore, mandatory stay provisions resulting from bankruptcy could disrupt the proper distribution payments of the Sukūk. Consequently, contract provisions endeavour to restrict the purpose and activities of the issuer SPV. This is normally achieved by restricting its business purpose solely to the Sukūk transaction. These contract provisions are often required by various counterparties, including, in particular, the rating agencies, to be included in the constitutional documents of the issuer as well as in the transactional documents. Legal opinions should also state that the constitutional documents would be binding upon third parties.

Ensuring bankruptcy remoteness also requires a number of "severable" covenants to be imposed on the issuer, and rating agency guidelines are frequently interpreted to necessitate that these covenants are included in the constitutional documents of the issuer as well.

In a Shari‘ah-compliant transaction where perhaps a lease or Ijārah structure is used, such covenants raise two complexities because the position is often taken that they should apply to both the funding company lessor and the project company lessee.

First, the assets, financial statements and funds of the funding company are often shared with those of the project company. Therefore, the "separate" covenants can, in reality, be false. Second, should the covenants be included in the constitutive documents, even an immaterial breach will result in an ultra vires act and consequent personal liability for the directors.

The final set of provisions to ensure bankruptcy remoteness involves the originator, investors and credit enhancers agreeing not to initiate bankruptcy proceedings against the issuer. The issuer also undertakes not to initiate voluntary bankruptcy proceedings.

Additional Sukūk- (and restructuring-) related observations

One of the fundamental areas where insolvency concerns and Islamic finance are of great interest is where a Sukūk issue experiences difficulty. Examples of this would include the East Cameron Sukūk, Investment Dar and Dubai World.

Where restructuring is required in conventional transactions, a conversion of debt to equity is a commonly used technique. In an Islamic finance transaction, and more particularly a Sukūk transaction, where a form of restructuring is required, such a conversion is not always possible without a change to the original structure and possibly a reclassification of the Sukūk transaction as a whole.
As I stated earlier, "if the debtor is in a hard time (unable to meet the obligations) then grant him time till it is easy for him to repay; but if you remit it by way of charity that is better for you if you did not know it."

In a practical manner, this may be understood as:

- Restructuring through time extensions;
- Restructuring through a new contract, as in Beximco; and
- Application of Shari'ah-compliant rebates and "haircuts":
  - *Ibra’*, or rebates on the due obligations or indebtedness;
  - *Tanāzul*, or waivers of a certain portion of the due amounts; and
  - *Iqālah*, or dissolution through a willingness to accept losses.

The above actions or inactions may not always be possible to implement. For instance, a time extension may not be viable and may ultimately cost more money, which is a charge to the customer and could potentially be constructed as *Riba*. (However, if consideration can be shown for the extension, such a classification is unlikely.)

In terms of Sukūk defaults generally, as we have indicated earlier, the Sukūk certificate holders have on the face of it an undivided ownership of the underlying assets. However, the extent to which recourse can be made to the assets depends upon the structure of the Sukūk and whether there is a limited or non-recourse drafting in the documentation. It is possible that the Sukūk holders may have agreed to restrict their enforcement rights in this scenario as well.

### East Cameron Sukūk

One of the points we referred to above was considered in the *East Cameron Sukūk*. When this Sukūk went into default, the case was heard before the US Bankruptcy Courts and an attempt was made to argue that the Sukūk should be re-categorised as a secured loan, and that the certificate holder should not be regarded as being the owner of the Sukūk assets. This was not an unexpected argument, and in the first instance the court has rejected it and given consideration to a further plan of reconstruction.

### Investment Dar

Another example is the *Investment Dar* transaction, where an event of default arose out of a failure to pay a periodic payment distribution. A coordinating committee has been set up with a view to agreeing a restructuring plan with the company, the government and other creditors, which may involve a restructuring over a five-year period.

### Dubai World

The much-reported *Dubai World* difficulty is a case study in itself, and therefore we do not intend to discuss it in any great detail. However, it is quite clear that some of the aspects referred to above may also be relevant to the Dubai World
transaction; indeed, there is an ongoing process that has an effect on many different creditors.

**Practical concerns**

It is also important to consider, from a practical base, what steps stakeholders may need to consider or undertake when considering an Islamic finance transaction that enters into difficulty. The following are some suggested practical steps:

- Draft the documentation carefully in the first place to take into account some of the concerns referred to in this chapter.

- Be very careful to define what constitutes an event of default, and perhaps what the consequences of this may be in an Islamic finance context as interpreted in both a conventional jurisdiction and a Shari‘ah-compliance one.

- There may be instances where other creditors may need to join in the proceedings, which may include setting up a coordinating committee as was the case for Investment Dar.

- Possibly take on board the views of a Shari‘ah adviser working in conjunction with other advisers, including lawyers.

- As appropriate, serve default, reservation or rights – or, indeed, acceleration – notices, formulate standstill agreements, or agree on the form that restructuring can take.

Another thing to bear in mind is whether there has been any form of co-financing or, indeed, whether there are any non-Islamic creditors. A co-financing agreement can be helpful in this scenario, where access to the underlying security can be controlled jointly by the parties.

**6) Separate Legal Personality under Shari‘ah and the Corporate Veil**

The traditional *Shirkah* (partnership) does not have a unique legal personality independent from the legal personalities of its partners. On the one hand, countries in which Islamic courts are active, including Saudi Arabia, Pakistan and Malaysia, have all recognised the existence of the modern corporation and limited liability entities without significant challenge. On the other hand, many Shari‘ah scholars who actively work in the field of Islamic finance and, indeed, write or opine on it remain uncertain or differ in their views on whether the concepts are fully Shari‘ah compliant. It is also fair to say that those Islamic legal systems that have allowed limited liability entities have probably taken a pragmatic view of there being a public benefit in doing so. Additionally, corporate personality itself is not a Haram concept.

When it comes to the insolvency of a business venture that has been structured in a Shari‘ah-compliant manner, we have not seen instances of the corporate veil being lifted solely because the structure was constructed to comply with Shari‘ah. Those instances where the corporate veil has been lifted have mostly been in cases where a separate legal personality concept was being used to perpetrate a fraud or for tax evasion purposes.
7) Murābahah Transactions

It is clear that many of the insolvency-related cases discussed above deal with a form of Murābahah transaction. While there are a number of ways in which Murābahah transactions can be structured, it might be helpful to comment on two specific structures, as follows:

- Under a Commodity Murābahah, a refinancing can take place through a replacement Murābahah. Issues do arise, however, if the underlying customer is technically insolvent. In that case, bankruptcy-related legislation may possibly attach to the original Murābahah as well as the refinancing Murābahah.

- Under a trade Murābahah, a widely used technique is to sell the asset back to the financier for an amount that is used to clear the deferred sale price obligation under the original trade Murābahah, and then to lease the asset back to the customer using perhaps an Ijārah financing transaction.

8) Ijārah Transactions

Again, a widely used structure is the Ijārah. A typical scenario arises where the tenant defaults and does not, or is not in a position to, exercise its purchase undertaking obligations where there is a requirement of the financier (or the lessor under the Ijārah lease) to sell the asset. If the lessor actually exercises this right, appropriate drafting needs to be built into the documentation to allow the excess in the realised price for the asset to be paid back to the customer.

V. Conclusion

Given that Islamic finance transactions in conventional jurisdictions are still fairly novel and limited, albeit the volume is growing rapidly, there is limited availability of precedents or information in relation to the impact of insolvency or, indeed, in the volume of reported cases. However, there remain some general, yet relevant, challenges that Islamic finance faces in the global market.

First, there is a shortage of properly qualified Shari'ah scholars; added to which, there is currently no universal accepted standard on what makes a person "qualified". Second, there is no global consensus on interpretations of Shari'ah, especially in the context of innovative financial products.

Islamic finance is undoubtedly having a major impact in the global financial world. The growing number of counterparties in a commercial transaction wishing to rely on Shari'ah-compliant structures is driving innovation in both conventional and dual banking systems.

The issues of insolvency in Islamic finance have been explored – but, in reality, only on the surface. Where they have been considered at the outset, they have been dealt with mainly through tailor-made contract provisions that deal with likely and potential issues. There are also some instances of legislation protecting those deemed to be most vulnerable.

From the above, the general feeling seems to be that harmonisation with secular systems is possible, but that there will be certain specifics which may present issues. In particular, it would be helpful to:
• Revisit, in due course, the various cases where a restructuring or further thought has been given to dealing with an insolvency-type situation arising in an Islamic finance transaction;

• Look at the different concerns of stakeholders – for instance, investment account holders and institutions offering Islamic financial services. In particular, there is a debate as to whether investment account holders rank in the same way as equity owners of the business or, indeed, as a customer. This is further complicated by the practice known as "smoothing returns", which provides some form of guaranteed return prior to equity holders being paid; and

• Conduct a more detailed survey as an extension of the one that was originally conducted a few years ago\(^2\) to take into account dispute resolution mechanisms in various different countries and how they impact on insolvency concerns.

However, in my view, while the position is far from clear and satisfactory, there are strong suggestions that Islamic finance does not harbour more risks than conventional financing methods. The resultant growth in the use of Shari‘ah-compliant structures is a positive sign of consumer and investor confidence.

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CHAPTER TWO

COMMENTARY PAPERS BY EXPERTS

COMMENTARY ONE:

SHARĪ‘AH CONSIDERATIONS IN THE BANKRUPTCY CONTEXT AND THE FIRST BANKRUPTCY (EAST CAMERON)

By Michael J.T. McMillen

COMMENTARY TWO:

ISLAMIC FINANCE AND THE IMPACT OF INSOLVENCY

By Dato’ Dr Nik Ramlah Nik Mahmood and Wan Abdul Rahim Kamil
COMMENTARY ONE:

SHARĪ’AH CONSIDERATIONS IN THE BANKRUPTCY CONTEXT AND THE FIRST BANKRUPTCY (EAST CAMERON)

Michael J.T. McMillen

I. Introduction

The reach of Islamic finance is now global. Sharī’ah-compliant financings are now frequent both in jurisdictions in which the Sharī’ah is an element of the secular law, and in purely secular jurisdictions in which the Sharī’ah does not comprise an element of the secular law. To date, practitioners of Islamic finance have focused heavily on the development of structures that allow Sharī’ah-compliant financings in these jurisdictions. The global financial crisis that commenced in 2007 has raised a new set of issues pertaining to how secular bankruptcy and insolvency regimes will address Sharī’ah-compliant transactions. And, not surprisingly, a Sukūk transaction has become the subject of a formal bankruptcy proceeding, thereby moving the debate, for the first time, from the purely theoretical to the immediately practical.

This essay is an introductory survey of three areas of bankruptcy and insolvency theory and practice that relate to the question of whether Sharī’ah principles pertaining to bankruptcy and insolvency can be introduced into secular bankruptcy and insolvency regimes in Sharī’ah-incorporated jurisdictions and purely secular jurisdictions. The objective of this survey is to focus attention on some initial policy issues that arise in connection with that question as it is considered in the context of bankruptcies and insolvencies of entities having large capitalisation. The essay first summarises some of the Sharī’ah principles that are applicable in the bankruptcy and insolvency context. Thereafter, the essay notes the general nature of the secular bankruptcy and insolvency regimes currently in use and summarises some current practices that are of relevance in the distressed debt, bankruptcy, insolvency, reorganisation and workout markets, particularly in jurisdictions that have adopted a reorganisation (or “Chapter 11”) restructuring methodology. Finally, the essay summarises certain aspects of the bankruptcy proceeding involving the East Cameron oil and gas Sukūk as an example of a secular bankruptcy/insolvency proceeding involving a Sharī’ah-compliant instrument and transaction.

1 Mr Michael J.T. McMillen is a member of the bar of the State of New York
2 This essay will treat “bankruptcy” (a situation or system in which an insolvent person or entity has recourse to courts for the ordering or administration of his, her or its affairs; the term is often used interchangeably for the term “insolvency”) and “insolvency” (the state of balance sheet insolvency and income statement or cash flow insolvency) as largely interchangeable concepts (much to the horror of purist theoreticians and practitioners). This is a convenience for the purposes of this essay, and has been adopted because of the great range of secular bankruptcy and insolvency regimes that may be considered, eventually, as appropriate for the introduction of Sharī’ah-related bankruptcy and insolvency concepts. There will be plenty of time to make finer differentiations.
3 This essay is a summary of the author’s presentation, of the same title, at the Roundtable Discussion organised by the Islamic Financial Services Board and The World Bank on Insolvency Regimes for Islamic Finance, which was held on 10 October 2010 at The World Bank in Washington, DC.
4 Bankruptcies and insolvencies of entities having large capitalisation (millions or billions of dollars) are fundamentally different from bankruptcies or insolvencies of entities having smaller capitalisation. See Douglas Baird, Arturo Bris and Ning Zhu, The Dynamics of Large and Small Chapter 11 Cases: An Empirical Study (draft of January 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=866865. retrieved 10 November 2010
5 The East Cameron bankruptcy proceeding is believed to be the only formal bankruptcy proceeding in the world, to the date of this writing, involving a Sharī’ah-compliant instrument and transaction.
II. Bankruptcy (Iflas) under Shari’ah Principles

The Qur’anic basis for bankruptcy concepts, including embodied concepts of social responsibility and charity, is: “If the debtor is in a difficulty, grant him time till it is easy for him to repay. But if you remit it by way of charity, that is best for you if you only knew.” This conception is balanced by the Qur’anic conception, interpreted to provide that it is a sin, not just a legal obligation, to not pay your debts (and perform your obligations) if you have the capacity: “O you who have believed, fulfill [all] contracts.”

There is no concept that requires or justifies the discharge of debts under the Shari’ah (other than payment and performance and certain doctrines of fraud and the like). On the other hand, the amount of debt is not increased due to delay of payment (and, of course, the Riba doctrines prohibit increases in the debt over time, even where the debt is not paid when due). Thus, if the debtor can repay, the debtor must repay. If the debtor is not able to repay, there is no moral or legal requirement or penalty.

Iflas, or bankruptcy, covers both: (a) balance sheet insolvency, in which liabilities exceed assets; and (b) income statement or cash-flow insolvency, in which there are insufficient liquid assets (including revenues) to pay debts on a current basis. A Mufflis is a bankrupt person or entity (male, female or business entity). Under the Shari’ah, there is no distinction between a business bankruptcy and an individual bankruptcy and between bankruptcies of large entities and bankruptcies of small entities. Mufflis status ends only by (a) repayment of the indebtedness or (b) death.

A bankruptcy or insolvency proceeding under Shari’ah principles is commenced by one or more creditors (but cannot be commenced by a debtor). A debtor is obligated to pay in accordance with his, her or its agreement and is not entitled to initiate a proceeding, based upon bankruptcy or insolvency, to relieve the debtor of a repayment obligation. Thus, a bankruptcy or insolvency proceeding under Shari’ah principles is always an “involuntary” proceeding. This, of course, is in contrast to the voluntary bankruptcy alternatives embodied in many, if not most, secular bankruptcy and insolvency regimes.

“Creditors” that are entitled to initiate proceedings or make claims under Shari’ah principles are only those with respect to matured debt. In considering the nature of “matured” debt, it is important to note that debt is usually not accelerated under applicable Shari’ah principles; it becomes due in accordance with the original repayment schedule (even where payment is in default and remedies are being

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6 Qur’an, 2:280.
7 Qur’an, 5:1.
8 Sources, particularly English language sources, that discuss the Shari’ah principles applicable in the bankruptcy and insolvency context are difficult to locate. The author has consulted IbnRushd, The Distinguished Junis Primer, Volume II, Bidayat al-Mujahid w Nilayat al-Mughnasid, and Abed Awad and Robert E. Michael, “The Islamic Law of Bankruptcy”, a draft paper (undated draft of approximately July 2010; copy on file with the author) which relies significantly upon Ibn Qudamah, Muwaffaq al-Din Abu Muhammad Abd Allah Ibn Ahmad Ibn Muhammad, Al-Mughni fi fiqh imam al sunna ahmad ibn habal al shaybani. The author has also consulted various contemporary Shari’ah scholars with respect to discrete issues. (Any errors in understanding or conveying the positions of those scholars are the sole responsibility of the author.)
9 The non-performing party will be responsible for actual damages (although not consequential damages) caused by a default or breach.
10 Consider, however, Mulazamah (“close attachment” or “cling to” debtors), as discussed in Farhat J. Ziadeh, “Mulazamah or Harassment of Recalcitrant Debtors in Islamic Law”, 7 Islamic Law and Society 289 (2000).
11 Debt can be compliant with the Shari’ah (e.g. a rent obligation under an ijaraah) or not compliant with the Shari’ah (e.g. an obligation to pay interest on a non-compliant loan). This essay does not distinguish these categories (although there is obviously much to distinguish), and assumes, for the moment, that all debt of the debtor is compliant with the Shari’ah except as otherwise noted in this essay.
12 The Shari’ah does not recognise corporates and other entities that limit personal liability. This is a complexity in considering the application of Shari’ah concepts to secular bankruptcy and insolvency regimes. For example, does this render most partnerships into “general partnerships” for Shari’ah purposes? These principles will need to be carefully considered prior to attempting to incorporate Shari’ah bankruptcy and insolvency principles in a secular system.
pursued). This is in sharp contrast to the “claim” orientation of secular bankruptcy and insolvency regimes.

Under applicable Shari‘ah principles, upon initiation of a proceeding, a judge distrains the debtor pending a determination of whether the debtor is a Mufflis. This has the effect of freezing the debtor’s assets pending the determination. This compares with some equivalency to the automatic stay provisions of secular regimes, but stands in marked contrast to the events after the determination that the debtor is or is not a Mufflis.

A receiver will be appointed: (a) to manage the debtor’s business and assets (subject to judicial and creditor approval); and (b) then liquidate the business and assets of the debtor in an auction. The management of the debtor’s assets during the pendency of the proceeding bears both similarities to and differences from different secular systems in which the manager or a trustee manages the debtor’s business during the proceedings. The Qur’anic injunctions noted at the beginning of this section do not seem to mandate that liquidation be the only available outcome under relevant Shari‘ah principles. It would seem that reorganisation and restructuring, at least as a matter of mutual agreement among the debtor and the creditors, should also be a permissible outcome. It is important to explore the doctrinal underpinnings, from a Shari‘ah vantage, of these alternatives given the current trend, under secular law, favouring reorganisations and restructurings in accordance with a “Chapter 11” or renegotiation and reorganisation format.

Upon commencement of a bankruptcy or insolvency proceeding under Shari‘ah principles, the creditor’s rights attach to the debtor’s property and the debtor is viewed as a minor, insane or incapacitated person for purposes of legal status. The debtor cannot manage and cannot dispose of his, her or its property. Each of these circumstances stands in stark contrast to secular principles.

There is no bankruptcy or insolvency “estate” under Shari‘ah principles. The property of the debtor (the equivalent of the “estate” under secular law principles) is comprised of all assets of the debtor. Claims against that property are defined as all third-party claims that are matured and due to the debtor, which is somewhat different from the “claims” concepts used under most secular bankruptcy and insolvency regimes. Creditors that can locate his, her or its specific property have a greater entitlement to that property than other creditors, which is somewhat akin to secured creditors concepts under secular law.

As a general statement, creditors and debtors may voluntarily settle or compromise, settle, reorganise and restructure the debt. However, different Madhâhib do not accept all kinds of settlements, a point that will need to be carefully investigated in connection with the implementation of any reorganisation or restructuring or “Chapter 11”-based system. For example, some Madhâhib do not accept settlements to avoid litigation, especially where the debtor does not dispute the validity of the debt, and some Madhâhib treat a settlement where the debtor admits the validity of the debt as unlawful taking of the creditor’s rights, except where the compromised debt is clearly a gift.

For comparative purposes, it is interesting to consider the Shari‘ah principles applicable to certain types of creditors. Reclamation creditors are creditors that are reclaiming specific property of the creditor that is in the possession of the debtor. Return of property of that type requires satisfaction of five elements: (i) the debtor is alive at the time of the return of the property; (ii) the property is not destroyed or damaged; (iii) the property remains in the possession and control of the debtor;
(iv) where the debtor has paid an instalment in respect of the debt, the debtor must exercise the option to receive repayment of the instalment in order to retake the property; and (v) there must be various satisfactions and elections under laws pertaining to modified property (e.g. improvements to land in the possession of the debtor), which are complex. A lessor, in a lessee bankruptcy or insolvency proceeding, can annul leases and take back their property. They also have various priorities to accretions to their property (e.g. a rent priority over proceeds of sale of crops from rented land). A lessee in a landlord bankruptcy can continue the lease in accordance with its terms (on the basis that the lessee has a possessory interest like a Rahn). Secured creditors have a priority against the collateral provided as security under the applicable Rahn. These principles are quite similar to secular bankruptcy regimes, although the possessory nature of the Rahn is different than most secular lien concepts.13

Similar to secular bankruptcy and insolvency laws, various personal exemptions exist, such as those pertaining to certain living expenses, tools of trade, homes, and the like. These are not usually of relevance in commercial bankruptcies and insolvencies. There are also various priorities of specific unsecured creditors, such as wages of farm workers, fees of an artisan for completed work, and fees for transporters of goods.

Regular unsecured creditors share pro rata in the remaining assets of the debtor. It is important to note in this regard that, under the Shari’ah principles, there is no final "discharge" of indebtedness: the debtor remains obligated to pay his, her or its debts until payment in full of those debts (or earlier death). This stands in stark contrast to most secular bankruptcy regimes.

The foregoing is a summary of only a few of the Shari’ah principles and Shari’ah-related issues that arise in the bankruptcy and insolvency context. A great deal more research needs to be done on the Shari’ah principles pertaining to bankruptcy and insolvency. A rigorous comparison and contrasting with secular legal systems cannot be undertaken until the Shari’ah principles are more carefully explored, but is a necessity after these principles are further explored and prior to any effort to implement Shari’ah principles in a secular system.

From my very preliminary discussions with Shari’ah scholars, the general feeling seems to be that harmonisation with secular systems is feasible on a wide range of matters and that some specifics may present issues that will need to be explored in detail. The consensus seems to be, however, that we are not yet at the point of being able to do the rigorous comparisons and contrasting. Fundamental research on the Shari’ah principles should be the first order of the day.

CHAPTER TWO: COMMENTARY PAPERS BY EXPERTS

III. Bankruptcy Concepts and Distressed Investing

A. Some Fundamental Principles

As a general statement, secular bankruptcy and insolvency laws tend to be classified as either “creditor friendly” or “debtor friendly”. The insolvency regime of the United Kingdom is often cited as the paradigm of a creditor-friendly regime: a proceeding, once instituted, is directed toward the liquidation of the assets of the debtor and payment of the creditors. Chapter 11 of the United States Bankruptcy Code is often cited as the paradigm of a debtor-friendly regime. Chapter 11 is focused on renegotiating and reorganisation of the affairs of the debtor and giving the debtor a “second chance”, after the reorganisation, to continue to conduct its business and affairs. Importantly, however, whatever the tendency of the regime, once an entity is in distress or financial trouble, the creditors take control and the equity holders are relegated to a distinctly secondary position. This transfer of power generally tends to follow the...
conventional understanding of the priority that creditors have over shareholders in the repayment of the entity’s obligations and the principle of “absolute priority”. The absolute priority principle states that a debtor must provide for full payment to creditors before making any payment at all to shareholders. Shareholders must surrender to creditors that portion of the shareholder's ownership necessary to compensate the creditors for the debt reduction. If total debts exceed the total value of the entity’s assets, all equity will be surrendered and the creditors will become the owners of the entity through a debt-to-equity conversion.

Bankruptcy and insolvency law was developed at a time when capital structures and the predominant and most commonplace types of financial instruments were quite different than they are today. When these laws were developed, the general categories of creditors were (a) secured creditors, (b) bondholders (generally holding publicly issued bonds), (c) trade creditors, and (d) holders of publicly traded stock. Conceptually, secured creditors were conceived of as desiring safety and being focused on repayment of the secured indebtedness out of the specific collateral afforded to those creditors. They were presumed to have relatively little regard for maximisation of realisation from the assets of the debtor beyond the amount of their secured indebtedness. Equity holders, on the other hand, were thought to have the greatest willingness to take risks during and after the bankruptcy and insolvency process. Being at the bottom of the capital stack in terms of their ability to receive payments of any type, they have the greatest motivation to see the debtor entity continue as a going concern. The unsecured creditors were conceived of as having a desire for value-increasing changes in the debtor and the capital structure so as to increase their returns out of future operations. (Returns from liquidation of most of the assets will be directed to repayment of the secured indebtedness.) The bankruptcy and insolvency laws were, and remain, designed for the benefit of the unsecured creditors, primarily the general creditors.

Secured creditors were left to fend for themselves, and, as a matter of policy, that arrangement was thought quite acceptable and appropriate. The secured creditors had a claim on specific assets (their collateral security), and could protect themselves by foreclosing on the mortgage, deed of trust or other security interest in that collateral. That collateral was likely structured, at inception, to over-collateralise the secured claim. And it is likely, given the relative negotiating positions of the debtor and the secured creditor at the inception of the secured financing, that the secured creditor had a strong position that allowed it to maintain, through loan-to-value, collateral maintenance and other covenants, the desired degree of over-collateralisation. The secured creditors were assumed to have a bias toward liquidation. Continuing operation of the business would expose them to greater risk of not realising on their collateral. And, in any liquidation, it is believed that the secured creditor would not strive to realise full going concern value; that they would desire to obtain only enough to satisfy their own claims. If and to the extent that collateral security were insufficient to totally secure the outstanding secured indebtedness, the secured creditors became general creditors to the extent of the excess of such indebtedness plus expenses and damages in connection with a default over the amount realised on the collateral security.

18 Sensitive, and intensely debated, valuations issues arise in connection with any such conversion.
During the pendency of the bankruptcy proceeding, secured creditors are allowed interest and fees arising from their claim if there is an “equity cushion” (the value of the property above the amount owed to the secured creditor that will shield the interest from loss due to any decrease in the value of the property). Secured creditors are entitled to “adequate protection” that the value of its collateral is and will remain undiminished (and adequate protection cannot take the form of equity in the reorganised business). If the security interest of the secured creditor is left intact under the reorganisation plan, the secured creditor has no vote or voice in reorganisation. Changes to the secured creditor’s claim can affect only repayment terms (e.g. the tenor of the secured claim may be increased, although only if the collateral is adequate).

Each creditor has a “claim” that can be reduced to judgment and that will entitle the claim holder to a pro rata claim against and a pro rata realisation upon a portion of the bankruptcy estate.\(^\text{19}\) The rules pertaining to the definitions of different classes of claims are intended to group and align similar types of claims and ensure that claims at the same priority level are treated alike, particularly in a bankruptcy and insolvency regime that provides for reorganisation and restructuring (rather than only liquidation of the debtor’s assets). Creditors within a specified class have the same legal rights and the same entitlements (pro rata treatment). Their entitlements and interests are thought to be sufficiently aligned so as to justify having the decisions of a specified percentage of the group bind the entire group. Thus, a small committee of the largest unsecured creditors can look after the interests of all unsecured creditors and, because of the similarity of interests, the decisions of the group as a whole can bind all members of the group, including dissenting members.\(^\text{20}\)

The decision-making authority of the unsecured creditor’s committee is further justified by the informational flow to the creditor’s committee, and thence to the unsecured creditors. The thinking is that the existence and functioning of the creditor’s committee allows unsecured creditors to obtain information to make informed judgements. Creditors that sit on the creditor’s committee have both a fiduciary duty and adequate economic interest to represent the unsecured creditor’s group as a whole.

Expenses, including for experts retained by or on behalf of the creditor’s committee, are shared and spread over the entire general creditor group.\(^\text{21}\) The assumption of bankruptcy law is that secured creditors are paid in full out of their collateral and so residual amounts are for the account of the general creditors, who pay these expenses.

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\(^{20}\) 11 U.S.C. § 1102 (2006) provides for the committee of creditors; § 1122(a) provides for substantial similarity among claims in a class; § 1123(a)(4) provides for identical treatment of claims in a class; § 1103(c)(2) provides the committee with power to investigate the acts, conducts, assets, liabilities, financial condition and business of the debtor; § 1103(a) gives the committee the power to employ attorneys, accountants and other agents; and § 503(b)(3)(F) includes expenses of the creditor’s committee as administrative expenses.

\(^{21}\) Administrative expenses are paid after the secured creditors and before the general creditors. See 11 U.S.C. §506 (2006), relating to determination of secured status, and § 507, providing for priority of payment of the administrative expenses over most unsecured claims.
B. Creditor Metamorphosis

Since the promulgation of the bankruptcy and insolvency laws recognising debtor reorganisation as a leading principle (i.e. since 1978), there have been dramatic changes in both the nature of secured creditors and in the types, objectives and strategies of general creditors.22

Prior to 1978, there was frequently a single secured creditor to a commercial enterprise (or a very limited number of creditors). Often, that creditor was a bank that knew the debtor well and had, and intended to continue to have, an ongoing relationship with the debtor. And then came syndication, trade claims trading, second lien positioning, debtor-in-possession financing, § 636 sales and derivatives, among other developments.

Banks and other financial institutions that act as lenders sought to sell off a portion of their secured loans, for very laudable risk diversification reasons. They determined that their risk-diversified position was significantly sounder if they sold off – syndicated – (say) 80% of each loan or financing that they made, and retained only 20% of each such loan or financing. They used the cash obtained from selling that 80% portion to purchase positions (say, 20%) in loans and financings made by other banks and financial institutions. When a piece (say, 20%) of a loan or financing was syndicated to each of four other banks or financial institutions, each purchaser obtained voting rights and economic interests equal in percentage to the percentage interest purchased by that other bank or financial institution. Thus, between the mid-1980s and the mid-1990s large loan syndications increased from roughly US$100 billion to US$1 trillion-plus.

The originating bank or financial institution, the lead arranger, would remain as the lead bank on the secured loan, holding the largest piece of the loan, and would continue to have the primary role in dealing with the debtor. However, it is clear that all the relationships between the debtor and each of the creditors had changed dramatically. The lead arranger had much less investment in, and a diminished relationship with, the debtor. The other creditors (the syndicants now holding 80% in total of the loan or financing in our example) had a fragmented, diminished relationship with the debtor, and may have had little or no direct relationship with the debtor. They would hold a portion of the obligations and rights of lenders, but in a diminished risk position and with different objectives than when they were sole lender. Further, they now had the ability to trade the syndicated piece in the secondary markets, which provided them with an early exit from the transaction should they so desire. (It is worth noting in this regard that secondary market trading of syndicated loan pieces has increased by many multiples since 1987.) Clearly, the dynamics of the financing and the relationship had changed. Secured loans have become more like unsecured general obligations.

The development of claims trading has had a significant impact on the changing composition of creditors in Chapter 11 proceedings, particularly on the involvement of

hedge funds, private equity funds, and banks and investment banks that have proprietary trading desks in distressed debt investing. Claims trading works as follows: Debtors cannot pay prepetition debt. However, many creditors, particularly trade creditors, cannot wait until the end of the bankruptcy proceeding to be paid. They need to cash out their claims on an ongoing basis without significant delay. Their economic positions are such that their trade claims need to be monetised as soon as possible after those claims arise, even if monetisation is at a low realisation rate relative to the face amount of the claim. Hedge funds, private equity funds and banks, among others, perceived the opportunity to purchase the trade claims of bankruptcy debtors. They saw an opportunity to realise an immediate premium from the impatience of trade creditors. These hedge funds, private equity funds and banks have more knowledge of debtor situations and the likelihood of different bankruptcy outcomes. They have longer time horizons than the trade creditors. They seek to find overlooked value in the debtor’s instruments. And, because of their knowledge, sophistication and resources, they are frequently able to use the ownership of trade claims as yet another vehicle in their strategic efforts to obtain ownership and control of the debtor via the reorganisation process.

Yet another development in the distressed debt markets in recent years is the increase in second lien loan financings. These financings increased from US$8 billion in 2003 to US$29 billion in 2006. These transactions involve a second lien loan that is made to the debtor with the consent of the first lien lender. (The first lien holder has a lien on virtually all of the assets of the debtor.) Payment on the second lien loan is not subordinated to the first lien holder; the debtor must make payment on both the first lien loan and the second lien loan. The second lien loan is second only in terms of its claim on the collateral package. There is a vibrant secondary market for second lien loans of this type. The primary purchasers in this secondary market are hedge funds, private equity funds and proprietary traders. Second lien holders are aggressive participants in bankruptcy and insolvency proceedings. They tend to push their rights to the limit, often objecting to the use of its collateral and seeking adequate protection of their secured interests (resisting the first lien holders). Their rights are derived from the inter-creditor agreement with the first lien lender, which is often heavily negotiated at the time of the incurrence of the second lien loan. The inter-creditor agreement frequently gives the first lien lender the right to sell collateral without the consent of the second lien holder and provides the first lien lender with the right to provide debtor-in-possession financings ("DIP Financings"), with super-priorities in favour of the provider of the DIP Financing (the "DIP Lender"). The second lien lenders will frequently contest these rights, including the super-priority lien provisions.

23 Baird & Rasmussen: Anti-Bankruptcy, supra note 21, at 12: “The changing composition of creditors in Chapter 11 is due more than any other reason to the rise in claims trading.” The discussion of claims trading in this essay follows the discussion in Baird & Rasmussen: Anti-Bankruptcy. See, also, Jonathan C. Lipson, “The Shadow Bankruptcy System”, 89 Boston University Law Review 1609 (2009) (“Lipson”), as to the changing composition of creditors and the ramifications of that change in composition, including, at 1645–1646, as to claims trading.


25 Some other developments have also had a marked effect on the markets here under discussion. For example, credit default swaps came into widespread use during the period being discussed. Credit default swaps allowed banks to offload default risks outside the banking system. In a credit default swap, one party acquires a credit risk for a fee, and makes payment in the amount of the loan if a “credit event” (including a bankruptcy) occurs. There is a fundamental difference between a credit default swap and a syndication: voting and control rights are not transferred in a credit default swap. In a credit default swap, a bank, hedge fund or other transferor may benefit from a default or a bankruptcy (it gets paid under the credit default swap) and it may thus act against the interest of the credit holder, a moral hazard and a discontinuity. Total return swaps are another derivative instrument that came to prominence in the period under discussion. In a total return swap, an investor (a total return receiver) may enjoy economic rights in a loan without the control rights. (The investor gets all economic exposure of the loan (both credit and market risks), not just credit risks.) Investors can sell the total return swap positions in the secondary markets (often to hedge funds and other distressed debt professionals). The owner of a loan (the total return payer) exchanges the income from the loan and appreciation for a guaranteed income stream plus protection against capital depreciation. The owner off-loads economic risks associated with the loan, but retains the loan on its balance sheet and retains control rights. These contracts may not be settled in the event of default. These developments are discussed at Baird & Rasmussen: Anti-Bankruptcy, supra note 21, at 33–41.
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The identity and objectives of the other unsecured creditors have also changed markedly since 1978. Here again, hedge funds, private equity funds, and banks have assumed a major role, particularly in “distressed debt investing”. These investors (these unsecured creditors) are well-informed, experienced and sophisticated market participants that have their own agendas. They act independently in their own self-interest, rather than in common with the dispersed group of creditors (which may stress the fiduciary duty assumptions and requirements). Their objectives may be ownership (including via a “loan to own” arrangement), the ability to control bankruptcy proceedings, the ability to control the distressed or insolvent entity and, possibly, take control of the entity as an ultimate matter (such as through DIP Financing arrangements), and the ability to acquire assets at exceptionally low valuations.

In considering the role of these institutions and their actions in the bankruptcy and insolvency realm (broadly conceived), a debt holder’s influence depends upon three factors: (1) the characteristics of the debt, such as its amount and type (bearing in mind, for example, that a holding of greater than 34% of a class of debt constitutes a blocking position under many secular bankruptcy, insolvency and corporate laws (and company charters), and a position of greater than 50% constitutes a majority and controlling position); (2) relevant statutory rights (such as Chapter 11 reorganisation rights under US laws, or management, liquidation or trustee direction rights under applicable law); and (3) contractual rights that may supersede other rights (such as prepetition contractual rights and covenant and default rights under DIP financings).

These institutions may take positions that are quite different than those assumed by the framers of the bankruptcy and insolvency laws. For example, they may not want further information regarding the debtor in which they invest, as it may constitute insider information and restrict their ability to trade (so they may avoid committees and involvement with the debtor). In other circumstances, they clearly do want the additional information. In some situations, they may not want to sit on committees and have fiduciary obligations to other creditors that might conflict with their own agendas. In other circumstances, they may use their position on a committee to control the bankruptcy proceedings.

And consider the various possibilities associated with ownership of different classes of debt and equity by a single investor institution. Multiple class ownership provides the creditor with a wide range of tools and options in the bankruptcy and insolvency context. As noted above, the creditor may opt not to use or exercise one or more of these tools or options: these are frequently tactical determinations. However, the tools and options are valuable and comprise, individually and collectively, a powerful arsenal. They may disclose ownership in one class (say, equity) but not in others, which may mislead the public on their position with respect to a company. These holdings, and the absence of full disclosure, may allow them to mislead market participants and competitors. They may in fact own a competitor, and thus have competing interests that are unknown. As noted above, the creditor may be able to exert blocking positions by virtue of holding 34% of any given class of debt. This is a

26 Distressed debt investing is variously defined. One definition is investing in the debt of a financially troubled company where that debt carries a high risk of default or non-payment and, consequently, a high rate of return. A narrow definition, and one that is considered in the Shari’ah-compliant distressed debt context, is investing in the debt of a company that has commenced or is expected to commence a bankruptcy or insolvency proceeding. A broader, market-oriented definition is investing in debt with a yield to maturity of 1,000 basis points over the riskless rate of return. Historically, in Europe, distressed debt investing has been defined as investing in debt that is trading between 80% and 90% of par value, but more recently as between 90% and 95% of par value.

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particularly important strategic consideration where each class must approve a given matter by half in number of debt holders and two-thirds in amount of claims in that class. And consider that holding one or more classes of debt may also allow that creditor to play an instrumental role in defining the classes of debt, which, in turn, will afford that creditor greater flexibility in determining whether to pay a given class of debt or negotiate with a given class of debt as to how it votes on a given matter. Multiple class holdings also make it significantly more difficult for the debtor to weaken blocking positions by way of influencing definitions of the various classes. Multiple class holdings may allow the creditor to disguise its true objectives in holding any specified class of debt (or equity). And it may allow the creditor or equity holder to hedge its positions, even to the point where its primary incentive may be to induce bankruptcy (e.g. so that it can trigger a credit default swap on which it is the beneficiary), despite its holdings of other classes of debt and despite the fact that the debtor may be better off outside bankruptcy.28 Multiple class holdings may be an effort to realise a “fulcrum” capital structure position.29 Multiple class holdings may be most effective where the position of the creditor is undisclosed (such that, for example, the creditor can realise upon arbitrage opportunities or even induce sales or purchases of classes of the debtor’s securities or obligations). Holding a class of indebtedness may give the holder a seat on the debtor’s planning committee and on the unsecured creditor’s committee. It may allow the creditor to make powerful motions, such as a creditor’s motion for relief from the automatic stay provisions or to appoint (or remove) a trustee. It may allow the creditor to object to the use of cash collateral. It will allow the creditor access to financial information, business plans and other information. (The secured creditors usually obtain this material pursuant to covenant rights in the secured financing arrangements.) Multi-class ownership will also allow the creditor a more flexible strategic position in addressing cram down court approvals where not every class of debt approves a given matter. And, quite fundamentally, multiple class ownership will establish a larger stake in debtor entity and thus a greater voice in the decisions pertaining to that entity.

Taking a position in the secured debt also has some notable advantages. For example, secured creditors can demand payment in full of the secured debt before distributions are made to junior creditors. They can also block sales of assets that include their collateral. Secured creditors can “credit bid” their debt in asset sales involving their collateral.

C. DIP Financings

In bankruptcy, insolvency and distressed debt transactions in the United States (and other jurisdictions that allow or encourage financing of debtors), DIP Financings have assumed a particularly important role.30 DIP Financings are post-petition loans to

the debtor in the bankruptcy proceeding. Under the US bankruptcy laws, the DIP Financing receives the benefit of a “super-priority” claim and is paid before other priority claims. In some circumstances, with the consent of the court and with certain qualifications, lenders that made pre-petition loans will make, or participate in the making of, the DIP Financings and will consolidate their pre-petition loans with the DIP Financings. This consolidation has the effect of trumping pre-petition secured creditors and bootstrapping the pre-petition position of the DIP Lender.

The structure and terms of the DIP Financing are also used to exert influence over the debtor and achieve results desired by the DIP Lenders. The DIP Financing may be structured as a revolver of some type in order to force the debtor to borrow smaller amounts on a continuing periodic basis. This not only limits the exposure of the DIP Lenders, but also allows covenant testing of the debtor on a frequent periodic basis. The financial and operational covenants of the DIP Financing will also be used to exert control over the debtor, with increasing stringency over time. Thus, the various financial covenants may become more restrictive over time. Other financial covenants may impose minimum income requirements and reserve requirements that are difficult for the debtor entity to meet. Violation of the covenants will result in defaults, acceleration of the indebtedness, and foreclosure upon the assets and business of the debtor. That is, violations will result in a change in ownership of the debtor. The covenants may also allow the DIP Lenders to exercise remedies even during the automatic stay periods. The covenants may also provide for hands-on involvement of the DIP Lenders through the actions of a “chief restructuring officer”, who is required by the DIP Financing covenants. The DIP Lenders may also take seats on the board of directors of the debtor, thereby having direct involvement in the policies and operations of the debtor. Among the many management rights that may be afforded the DIP Lenders by way of the loan documentation are veto rights over operational changes, asset or business acquisitions, asset or business dispositions, and different types of transactions. The DIP Lenders may also use the loan documentation to provide themselves with a broad range of rights, such as rights to bid the debt for company assets. In short, the DIP Financing documentation is an exceptionally powerful vehicle in the hands of sophisticated creditors.

D. Section 363 Sales

Section 363 of the United States Bankruptcy Code permits the use, sale or lease of property of the bankruptcy estate, both inside and outside the ordinary course of the debtor’s business. It authorises a debtor to sell assets outside of the ordinary course of business.


course of business upon obtaining the approval of the bankruptcy court upon a hearing. These sales may be of discrete assets of the debtor or may entail a sale of the debtor as a going concern. Section 363 sales and actions are permitted in order to maximise the assets of the estate for the benefit of the unsecured creditors. The property constituting the bankruptcy estate can be sold “free and clear of any interest in such property of an entity other than the estate”. If the bankruptcy court determines that adequate grounds exist, the assets of the debtor can be sold free and clear of the debts, including secured debts. Section 363(h) permits a sale of the estate’s interest (and any co-owner’s interest) in the property of the estate. Section 363(f) sets out five criteria: if any one of these criteria is met, the sale is permissible (subject to the “adequate protection” requirements, which frequently means having the interests attach to the sale proceeds): (i) applicable non-bankruptcy law permits the sale of the property free and clear of the non-estate interest; (ii) such entity consents; (iii) such interest is a lien and the sale price is greater than the value of all liens on such property; (iv) such interest is in a bona fide dispute; and (v) such entity could be compelled, in a legal or equitable proceeding, to accept money in satisfaction of such interest.

DIP Financings are post-petition financings to the debtor in the bankruptcy proceeding. They are sometimes described as being of two types: (a) “loan oriented”, where the DIP Lenders, through strong financial and operational covenants, have significant leverage over and control of the debtor and its operations; and (b) “loan and control” or “loan to own”, where the DIP Financing is used to transfer control to the DIP Lender itself, either through a sale to the DIP Financing provider or as the intended outcome of the Chapter 11 proceeding.

Commentators have identified a number of risks that are associated with the provision of DIP Financings. The DIP Lender may have too great an incentive to force the debtor to liquidate assets. The DIP Lender may use the DIP Financing to improve the status of the pre-petition loans made by that provider by consolidating pre-petition loans and post-petition DIP Financings into a single facility, with the consolidated loan having the benefit of the “super-priority”-afforded DIP Financings (thereby bootstrapping the pre-petition loan to a higher priority of payment). The DIP Financing may include particularly restrictive covenants that are designed to allow the DIP Lender to foreclose on the debtor’s business and take ownership of that business. The DIP Financing frequently diverts value from the general creditors to a very limited and select group of creditors that provide the DIP Financing. And the covenant and control provisions of the DIP Financing may stymie competing bids for control of a troubled company.


34 Section 1129 of the Bankruptcy Code, 11 U.S.C. 1129, requires that a court determine that a plan of reorganisation complies with the usual priorities of the Bankruptcy Code before that plan is approved, unless creditors consent to a plan deviating from those priorities. There are circumstances in which a § 363 sale might determine core aspects that would normally be addressed under § 1129 with disclosure, voting under § 1129(a)(8), and, if voting fails, judicial cram-down under § 1129(b). In such a case, there is a tension between § 363 and § 1129. Various bankruptcy scholars note that this tension was particularly acute in the recent Chapter 11 proceeding involving Chrysler Corporation. See, e.g., Mark Roe and David Skeel, “Assessing the Chrysler Bankruptcy”, 108 Michigan Law Review 727 (2009–2010), which is critical of the proceeding on various grounds.
IV. East Cameron Reorganisation Proceedings

The East Cameron oil and gas Sukūk is (to the author's knowledge) the only Shari‘ah-compliant instrument to be considered by a bankruptcy court in a formal bankruptcy or insolvency proceeding. It is a particularly useful example of the operation of a debtor-friendly bankruptcy and insolvency regime, as the bankruptcy proceeding was initiated under Chapter 11 of the United States Bankruptcy Code in the United States Federal bankruptcy court in Louisiana.

This case study allows us to raise a wide range of Shari‘ah-related issues for consideration. Let us consider an example of only one category of issues, albeit a category of fundamental issues. Is it permissible, under the Shari‘ah, to allow the occurrence of certain transactions that are not Shari‘ah compliant in circumstances where those transactions are a transitory expedient that will be reversed or unwound within very short periods and where those non-compliant transactions are necessary in order to comply with secular bankruptcy and insolvency law and where it is virtually certain that those transactions will have no lasting effect? Consider, for example, the use of an interest-bearing DIP Financing by the Sukūk Holders in the East Cameron reorganisation where the DIP Financing will be converted to equity in a short period. As we will see, this is one of many such issues that will need to be considered as we move to the introduction of Shari‘ah principles in the secular bankruptcy and insolvency context. We consider only a very few in this essay. But we do want to focus the reader on the necessity of careful consideration of all issues before precipitous action is taken.

The East Cameron oil and gas Sukūk was issued in 2006.35 East Cameron Gas Company (ECGC), a Cayman Islands limited liability company, issued US$175 million of Sukūk due July 2016 that were expected to have quarterly redemptions that depended upon hydrocarbon production from the relevant natural gas properties. ECGS is the “Trustee” of the Sukūk Trust pursuant to the Declaration of Trust, dated July 5, 2006. ECGC is also the “Issuer SPV” that issued the Sukūk certificates. ECGC and Louisiana Offshore Holding LLC (LOH), a Delaware limited liability company, as “Purchaser SPV”, entered into a Funding Agreement, dated July 5, 2006 (the “Funding Agreement”).

The Funding Agreement was the primary payment and cash allocation document in the transaction. Pursuant to the Funding Agreement, (a) proceeds from the Sukūk issuance were used to purchase various overriding royalty interests in the natural gas properties from the Originator, East Cameron Partners, LP (the bankrupt debtor), and (b) quarterly repayments would be made periodically to ECGC and paid to Sukūk Holders. ECGC, LOH and Deutsche Bank Trust Company Americas, as Collateral Agent, entered into various other documents pertaining to the Sukūk transaction, including the “Security Documents”.

The structure of the Sukūk transaction prior to the reorganisation in the bankruptcy proceeding is depicted graphically in Figure 1. Cash flow arrangements are highlighted in that figure. In brief summary, the progression of events pertaining to the default and initiation of the bankruptcy proceeding involving the East Cameron oil and gas Sukūk was as follows: On September 17, 2008, a Notice that an Exogenous Enforcement Event, namely a Hydrocarbon Mix Shortfall Exogenous Enforcement Event, was served on the Purchaser SPV and East Cameron Partners, LP, a Texas limited partnership (the “Originator”). On October 9, 2008, the Sukūk Holders, at a

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35 The author was a partner at the law firm that represented most of the Sukūk Holders in the East Cameron bankruptcy proceedings and was directly involved in those proceedings. As a result of confidentiality and ethics considerations, this essay draws upon only publicly available information pertaining to that proceeding and omits discussion of other relevant information and considerations.
meeting, adopted certain resolutions with respect to, among other things: (x) declaring the funding under the Funding Agreement immediately due and payable in full and applying the Accelerated Payment Schedule (in lieu of the Payment Schedule); (y) requiring the Purchaser SPV (LOH) to withdraw all amounts in the Earnout Account and deposit those amounts in the Collection Account; and (z) the exercise by ECGC and the Collateral Agent of the rights and remedies under the Funding Agreement and the Security Documents.

On October 16, 2008, the Originator/Debtor filed a voluntary petition for relief under Chapter 11 of Title 11 of the United States Code in the United States Bankruptcy Court for the Western District of Louisiana, Lafayette/Opelousas Division (No. 08-512-07). Also on October 16, 2008, the Originator/Debtor filed a complaint requesting injunctive relief against the Purchaser SPV (LOH), ECGC and the Collateral Agent – the “Adversary Proceeding” – to (i) prevent the sale, conveyance, transfer and liquidation of the overriding royalty interest (ORRI) that secured the obligations of the Purchaser SPV to ECGC under the Funding Agreement, and (ii) recharacterise the Sukūk as a secured loan transaction. On November 18, 2008, the Bankruptcy Court entered the requested preliminary injunction. On August 7, 2009, to fund Originator/Debtor operations during the pendency of the Chapter 11 bankruptcy case, various Sukūk Holders entered into a Debtor-in-Possession Credit Agreement and related documents to provide up to US$4,490,000 in loans to the Originator, which loans were secured by a first priority lien and security interest in essentially all of the assets of the Originator/Debtor. And at various times thereafter, the other events discussed in this essay occurred. Of particular import are the “363 asset sale” transaction and the conversion of the DIP Financing into equity, each as discussed below.

Figure 1: Inception of Sukūk Transaction: Highlighting Cash Flows
The East Cameron bankruptcy proceeding was a Chapter 11 reorganisation proceeding. The theory of Chapter 11 is as follows: Chapter 11 proceedings are relatively pro-debtor proceedings that provide for a reorganisation of the business and affairs of the debtor so as to provide the debtor with a “fresh start” and so as to preserve the debtor’s business. The debtor’s management stays in control of operations. Procedurally, the debtor has the exclusive right to propose the reorganisation plan in the first 120 days after the bankruptcy filing. Burdensome contracts and leases can be terminated. The debtor often reduces its debt by repaying some debt and discharging other debt. There is usually a consolidation of debtor obligations, and the debtor re-emerges from the bankruptcy proceeding as an operating business with a reconfigured capital structure. Existing equity holders may be removed or diluted. The reorganisation plan is the critical focus, but other factors may intervene (363 sales of assets, for example). In contrast to the theory and in common with many Chapter 11 proceedings in more recent years, the debtor (here East Cameron Partners) did not emerge as the operating business: a change of control was effected through a conversion of the DIP Financing to equity.

In devising a resolution to the issues that arose in the bankruptcy proceeding, the Sukūk Holders had to address a broad range of operational issues. The Sukūk Holders had to address issues pertaining to payment of unsecured creditors. They also had to provide for payments to the owner of the lease concessions, the Bureau of Ocean Energy Management, Regulation and Enforcement (formerly known as the Minerals Management Service), an agency of the United States Department of the Interior that manages natural gas, oil and other mineral resources on the outer continental shelf of the United States, which would have to subsequently consent to the reorganisation (to the extent of any change in the parties to the oil and gas leases). The Sukūk Holders had to arrange for a new operator and negotiate all matters with the new operator. And the Sukūk Holders had to determine how to keep the properties operational so that the working interests and related rights to the oil and gas would not be lost, which they accomplished when some of the Sukūk Holders (but not all) made a DIP Financing to the Debtor (East Cameron Partners, LP), as depicted in Figure 2.
Figure 3 illustrates some of the early steps in the conversion of the DIP Financing to equity in the East Cameron reorganisation. The existing trustee was replaced by a new trustee. The new trustee was a newly formed entity, EC Offshore Properties, Inc. (ECOP). ORRI LLC was formed as a subsidiary of ECOP (for use in a later step of the reorganisation). Two assignments were effected, one of the Funding Agreement and one of lender’s rights in respect of the DIP Financing in exchange for preferred stock in ECOP (which is held by some of the Sukūk Holders after the consummation of this step).

We note, without detailed discussion, an interesting Sharī‘ah issue that arises in connection with the conversion of the DIP Financing position to a preferred stock equity position. Preferred stock is generally defined as being “preferred” in two regards: there is a preference as to periodic payments; and there is a payment preference in liquidation, most notably liquidation in bankruptcy. The periodic payment preference is largely a matter of the timing of the payment (assuming, for the moment, that the obligation to make the payment on the common stock or non-preferred stock survives on a cumulative basis). This element of a preferred stock can be addressed from a Sharī‘ah perspective. The second element of preference, in the liquidation context, is more interesting in a situation such as the East Cameron bankruptcy because the transaction is already in a bankruptcy proceeding that focuses on reorganisation (rather than liquidation). Suffice it to say, for the moment, that the structuring of the preferred stock to address Sharī‘ah issues is a delicate undertaking in this type of scenario.

Figure 4 depicts the asset sales and transfers in the East Cameron reorganisation. A cash payment was made by the LOC Provider and certain Sukūk Holders (the “Contributing Holders”) to LOH, and the rights of ECOP under the Funding Agreement were extinguished. The ECOP assets, specifically the 72% ORRI and other assets of the Debtor, were transferred to ORRI and the DIP Financing obligations were
extinguished. (The state of the transaction after effecting these asset sales and transfers is depicted in Figure 6.)

Figure 4: Step 2: LOH Asset Transfer; Contributor’s Preferred Stock; 363 Asset Sale

Figure 5 summarises the state of the reorganisation after step 2.

Figure 5: Restructuring: After Step 2
The next step in the reorganisation involved the exchange of the Sukuk Certificates and certain LOC obligations for common stock of newly formed companies (that will acquire assets), as illustrated in Figure 6. Note that, like the original providers of the DIP Financing (which were Sukuk Holders), the LOC Provider obtained preferred stock. Note also that the Sukuk Certificates are retired, and the Sukuk Trust is dissolved, after the exchange of the Sukuk Certificates for common stock.

Figure 6: Step 3: Exchange of Common Stock for Sukuk and LOC Obligations

Immediately after the common stock exchange, ORRI LLC is consolidated into ECOP, as the final step in the reorganisation. The final capital structure is depicted in Figure 7. As can be seen from the figure, the Sukuk Certificates have been completely retired, the Sukuk Trust has been liquidated, and the Sukuk Holders are now equity holders in ECOP, which holds all of the interests in the oil and gas leases that were originally held by the Debtor. The equity interests in ECOP are both preferred stock and common stock, which presents some of the Shari'ah issues previously noted.
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V. Conclusion

The growth of Islamic finance, increasing comfort with the principles and operation of Islamic finance, greater sophistication of Islamic finance structures, and the unfortunate collapse of global financial markets are operating collectively to focus attention on the Sharia principles pertaining to bankruptcy and insolvency and issues that will arise in connection with efforts to introduce those principles into secular bankruptcy and insolvency regimes throughout the world. This essay has provided an introductory survey of some of the types of issues that will need to be addressed as those efforts progress.

It seems clear that a great deal of basic and fundamental research first needs to be conducted with respect to the nature and nuance of the relevant Sharia principles. This research will have to commence with first principles and advance, painstakingly, to the point where secular bankruptcy practitioners, as well as those conversant with Sharia concepts, can achieve a sound understanding of the Sharia principles and considerations. This will be no small task. Materials are lacking in every language, and are essentially non-existent in English. What does exist was formulated in commercial and financial markets that are quite different than those now existing.

The issues to be considered are legion. Starting at the level of fundamental principle, will the contemplated regime provide for reorganisation along the lines of Chapter 11 systems, or will liquidation be the essential thrust of the system? If, in line with international trends, the system will incorporate reorganisation concepts and principles, what is the Sharia basis for this regime? Even the fundamental questions are daunting. For example, consideration will need to be given to debt rescheduling concepts, debt forgiveness concepts, delayed debt payment concepts, equity conversion concepts, asset sale concepts, and differential equity conceptions. There will have to be consideration of whether voluntary bankruptcies can and will be permissible. And after agreement is reached on the basic nature and parameters of the system, the long road of discovery and elucidation of specific Sharia principles will have to be addressed. That undertaking will wind through a great deal of new territory, from the Sharia perspective, and will entail a comparative laws analysis, and a systemic comparison, unlike any in history.
It seems safe to say that not even the most preliminary formulations for implementation can be fathomed at the present time. But it also seems safe to say that successful implementation can be envisioned with a relatively high degree of confidence if the resources are brought to bear and the spirit of constructive enterprise is maintained.
I. Introduction

The issues arising from cases of insolvency under the various Shari’ah contracts of financing has been well outlined by the writer, Hamid Yunis, Senior Partner in the international law firm of Taylor Wessing, London.

In reading through it one could understand the frustrations that have arisen from the attempts to create the right protective barriers and provide appropriate legal recourses to the financiers as well as to the clients when situations go sour.

The Islamic finance community has always assumed that the secular courts of law could understand the complexities of the structures and the supporting financial contracts which are necessary, in order to ‘circumvent’ the elements of Riba or interests. It has also been assumed that the courts would understand the purpose of such structures and arrive at judgments based on Shari’ah interpretations. How the courts have deliberated and decided on the issues, in particular how the Shari’ah has been viewed and its relevance to the governing laws of contracts continues to be a focal point of debate and discussions in Islamic finance.

The issues that have arisen have shown that there is greater need for proper understanding of both Shari’ah and legal technicalities.

II. The Shari’ah View on Insolvency

To provide framework for insolvency regimes for Islamic finance, the concept of Shari’ah should be clearly understood and the specificities of Islamic financial contracts should also be considered. This is important in order to provide appropriate definition of insolvency from the Shari’ah perspective.

A. Definitions

In formulating the products and their related terms, the concept of insolvency must be viewed from various perspectives such as the Shari’ah, accounting and corporate law.

From the accounting perspective, insolvency is viewed as the unavailability of cash; or in evaluating the strength of the company, it would be the proportion of the
assets to liability. It would also be viewed as the outcome of the company’s or creditors cash-flow arising from its problems. The remedies could be from receivership actions or the voluntary liquidation of available assets. Corporate laws then decide on the hierarchy of claims by the creditors, arising from liquidation of the company. The ultimate insufficiency or delinquency would of course result in bankruptcy.

The *Sharī`ah* also defines insolvency as the incapacity to meet obligations and suggest remedies from an ethical perspective, as in the *Qur`an* “And if the debtor is in a hard time (unable to meet the obligations), then grant him time till it is easy for him to repay; but if you remit it by way of charity, that is better for you if you did but know.” [2: Verse 280]. Similar to conventional practices, the ultimate is also bankruptcy or *Muflis*.

Insolvencies could arise under several situations, such as the following:

- The incapability of the bank as the agent (*Wakil*) or *Muḍārib* to honour the obligations to the clients under special investments accounts resulting in bank run;
- The incapability of the client as the financed party, to honour the obligations to the financiers, such as between the lessor and the lessee; and
- The incapability of the special purpose vehicle, acting either as the *Mushārik* or the *Wakil*, to honour the obligations to the counter-party such as in the case of Nakheel.

**B. Islamic Financing Contracts**

Practical applications of the various forms of contracts by financial institutions are generally fall under two categories:

- Contract of exchange (*`Uqud al Mu`awadhat*) such as *Murābahah*, *Salām*, *Ijārah*, *Istisnā*; as defined by the author. Since the sale involved under these contracts, are under deferred payment or delivery terms, the contractual relationship between the involved parties are as debtor and creditor.

Under the above contracts, except for *Ijārah*, the obligations by the clients to the financiers are in the form of a commitment to the sale price of the commodity or asset. The form of settlement might vary in that it could be in a lump sum or in instalments over a duration of time, over the agreed time period for settlement.

*Ijārah*, being a rental contract would commit the client to an agreed period of rental on the basis of agreed scheduled rental rates.

- Contract of participations or investment (*`Uqud Ishtirāq*) such as *Mushārakah* (profit-loss sharing) or *Muḍārabah* (profit sharing). The application of these contracts is for funding or investment needs and the relationship between the parties and the originator as in *Mushārakah* are as investors; and in *Muḍārabah* as investors and entrepreneur.

Both contracts by their form are risk-participatory in nature, whereby the investors would be exposed to the risk of loss, if any.
When the contractual relationship between the parties is clearly defined, it would be easier to understand how the contract stands in cases of insolvency and the recourses available to the parties.

In cases of default, the Shari’ah principles will be superseded by the governing laws of the land, be it the common law or the civil law. Following the principles of contract that govern all transactions, sale of assets upon default will require a court order. For contracts of rental or ljárah, the termination process and the subsequent claims would be subject to provisions of the contract or the governing laws. The difficulties would arise in determining how the secular provisions on contract laws fit into the Shari’ah and not otherwise.

Are the contracts of Murâbahah, Bay’ Bithamin Ajil, Istisnâ’, ljárah or even Mushâarakah treated as loans? This is the issue that has surfaced in most courts such as in Malaysia, Abu Dhabi and Kuwait. The form of each contract is peculiar in itself but when the contracts are combined into composite structures, it is difficult to establish whether the ultimate contract is a straight sale or a debt. The application of purchase undertakings in Mushâarakah for example, has changed from and investment into a debt.

1) Acts Leading to Default

It is necessary to review the agreements to decide whether an event of default has occurred. It could be a failure to settle instalments or payments; or it could be a change in the structure of the contract entered into between the parties.

Under these circumstances the normal entitlements of the financier would be to accelerate payments or to exercise rights under a purchase undertaking.

   i. In a contract of exchange, insolvency occurs when the debtor is unable to meet his obligation and recourses would generally be by way of the court. Judgments would be on the settlement amounts and the liquidation of assets if there are collaterals.

   There are however several issues that need to be defined. Since the insolvency arises from a contract of exchange, the contracted liability should be the entire sale price of the commodities or assets. However since the application of these contracts are intended to facilitate financing needs, when a default occurs before the end of the contract period, the claims under the settlement amount should be viewed as accelerated payment. Therefore the claim should not be for the entire contractvalue. Disputes could arise in relation to this as in the Malaysian case of Bank Islam Malaysia Bhd v Ghazali Shamsuddin & Two Others. The High Court decided that the contract was un-Islamic. According to Abdul Wahab J. since the Bay’ Bithamin Ajil contracts were structurally faulty, the defaulters need not pay more than the financing amount that they received, depriving banks of the profit they would have otherwise booked from the transaction. The application of a sale contract as a financing mechanism had thus created confusion with respect to the real
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obligation by the client. The decision was revoked by The Court of Appeal which recognised the substance of the financing contract and ruled that the amount that the bank is entitled to demand upon a default is the balance of the bank's selling price, subject to the bank giving an *Ibra’* (or rebate), upon payment being received or realised. Thus it is obvious that clarity of the contracts is essential in order for right decisions to be made.

To use a *Shar‘i‘ah* sale contract for the purpose of financing thus needs more than the contract of sale. The sale is in order to deliver the substance of the contract i.e. to enable acquisition of assets under a credit structure, thus the need to address several issues such as:
- rebates over the entire contracted obligation in order to meet settlement needs, whether upon default or early settlements;
- events of default;
- recourse/s available by the financier; and
- mode/s of recovery for the outstanding indebtedness must be properly addressed in the agreements.

In the case of *Ijārah*, the amount claimable will arise from the purchase undertaking of the leased asset that will be effective upon default. Of course the issue is how capable is the client to pay for the value of the leased asset when he has been incapable of meeting the monthly rentals? The purchase undertaking is obviously to tie him to a liability under a purchase agreement and eventually to enable the financier to proceed with receivership or bankruptcy process.

What about under events of distress such as total loss due to a fire or total damage? The same application of purchase undertaking will take effect. However, in this case, there would be question as to what is to be sold when in the goods have been damaged by fire. Yet the client is expected to settle the balance of the capital, not recouped by the lessor.

ii. Under contracts of investments, there are two possible applications. The first will be the classical application of risk taking whereby the investors take risk of profit and loss. The second will be for the modified structures whereby the investment will be converted to specific business contract of exchange for the need of mitigating risks and losses for the investors. This second application has been the subject of much dispute arising from the purchase undertakings, in order to ensure capital protection for the investors. The concept of sale of legal rights and beneficial rights under this modified structure give rise to issues of indebtedness and ownership as in the case of East Cameron Gas.

Unlike the case of financing through a contract of exchange, the default in a contract of investment must be preceded by the dissolution event (normally termed as soft default) before the incapacity to settle the claims become a real or hard default. Thus, in order to avoid disputes,
the settlement amount needs to be defined and decided and the settlement mechanism must be transparent. The issues under this structure are thus more complex and normally arise in relation to Sukūk issuances. Hence need proper explanation on the structure of the transaction by the advisers from the outset.

In the case of Mushārakah Mutanaqisah or decreasing Mushārakah, the profit distribution must be clearly specified. Profits are set at the outset of the contract based on the initial proportion of shares or ownership between partners. However, as the shares move from one partner to another over time, the contract needs to be explicit on the profit distribution remaining unchanged over the tenure of the partnership as the idea is to enable one partner to not only recoup its investments but also to have a steady stream of fixed profits.

2) Settlement Amounts or Claims

The Qur`anic view of “then grant him time till it is easy for him to repay; but if you remit it by way of charity…” offers the following potential circumstances:

- Debt restructuring through time extensions. However, this will not be commercially viable for the financial institution, as it does not allow for further costs to be built into the extension. Such additions will be Riba.
- Debt restructuring through a new contract, as in the case of Beximco. In that case, the Murābahah indebtedness was refinanced by an Ijārah contract. The new contract of Ijārah facilitates the settlement of the original contract of indebtedness. New terms must be applied under this mode and it must be clearly understood that this restructuring exercise is to facilitate the settlement of the earlier contract. What needs to be made clear here is that the initial contract has been settled by an actual payment and not a ledger transfer. Debt restructuring must at all times observe the prohibition of kali-bil-kali (debt for debt), and thus settlement must be by cash.
- Applications of rebates or “haircuts”. This is a normal practice by conventional institutions, and the Shari`ah permits this to be done as follows:
  o Ibra’ – or a rebate on the due obligations or indebtedness;
  o Tanāzul – or waiver of a certain portion of the due amount; and
  o Iqlah – or dissolution through readiness to accept losses (conventionally known as “haircuts”).

The internal policies of the financiers must clearly state these possibilities.

III. Conclusion

Islamic financing are structured under the concepts and requirements of the Shari`ah; while the relationships and obligations as contractual obligations are governed by the laws of contracts, normally enforceable under the law of the land such as English, US or Malaysian laws as examples. Under such a situation, the substance
of the contract becomes the primary consideration rather than the form i.e. the structure of how this substance is achieved.

In most cases, the chosen governing law may not be appropriate to determine the legality and enforceability of the *Shari‘ah* principles. And this is generally the case. The cases that have been tried in the UK courts, particularly, have become benchmark cases that should guide the future documentation of Islamic finance contracts.

The issue of legal possession often becomes a contested matter in cases involving contract of sales. Under *Murābahah* transactions for example, when the bank purchase goods from a third party in order to resell the same to its client, the contested issue has been in determining whether legal possession by the bank has really taken place, and that the bank becomes liable for the goods.

The mainstreaming of Islamic finance requires that immediate attention be paid to providing the necessary protection to financiers, investors and clients.

The paper by Hamid Yunis has outlined the difficulties of managing the *Shari‘ah* issues in dispute resolutions. The challenge is not to ensure the placement of the *Shari‘ah* above common laws but to ensure proper understanding of the forms and structures of the Islamic financing contracts. The need is thus to ensure that the concepts of financing become accepted practice. This would call for the availability of commonly accepted definitions and practices in order to facilitate acceptance.

A possible remedy to enable recognition of *Shari‘ah*-compliant financing and investment contracts by the secular courts as stated by the writer is to identify “black letter” provisions in order to make the practices widely acceptable and to facilitate arbitrations. A well-known application of “black letter” provisions is in international trades and commerce under the International Chamber of Commerce (ICC) conventions. The standards not only afford clarity of commercial practices but also certainty.

What therefore should be considered by IFSB, or any other institutions such as AAOIFI, is the formation of international Islamic trade and finance convention. This will provide clarity and certainty in order to ensure efficiency in decision making and dispute resolutions. Such convention should have access to national governments, and cover a broad spectrum from arbitration and dispute resolution, to making the case for the practice of Islamic finance, trade and the market system. This convention can establish commissions especially on arbitration that would create a forum for experts to pool ideas and impart new policy on practical issues relating to international arbitration, the settlement of international disputes relating to Islamic finance as well as the legal and procedural aspects of arbitration.

Legal documentations on Islamic finance could therefore incorporate dispute and arbitration needs to the various standards and practices under the proposed convention, and thus give better clarification to issues.
CHAPTER THREE

COMMENTARY PAPERS BY CENTRAL BANKS

COMMENTARY ONE:

EFFECTIVE INSOLVENCY REGIMES FOR ISLAMIC FINANCE: THE PAKISTAN EXPERIENCE

By Inayat Hussain, State Bank of Pakistan

COMMENTARY TWO:

INSOLVENCY REGIMES OF THE ISLAMIC BANKING INDUSTRY: THE INDONESIAN EXPERIENCE

By Dr Dadang Muljawan, Bank Indonesia

COMMENTARY THREE:

INSOLVENCY REGIMES: REGULATORY, INSTITUTIONAL AND LEGAL CHALLENGES IN ISLAMIC FINANCE IN SAUDI ARABIA

By Dr Mohammed Al-Sheaibi, Saudi Arabian Monetary Agency
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COMMENTARY ONE:

EFFECTIVE INSOLVENCY REGIMES FOR ISLAMIC FINANCE:
THE PAKISTAN EXPERIENCE

Inayat Hussain

I. Introduction

Modern Islamic finance finds its root in Mit Ghamr Saving Bank, a cooperative organisation established in Egypt in 1963. The strength of that pioneering experiment saw a growing interest in Islamic finance and a number of institutions were established, especially during the 1990s. Presently there are more than 300 institutions with a presence in 75 countries offering Sharī`ah-compliant financial services. Given the inherent strength of Islamic finance, the interest in this discipline has spread beyond the Muslim countries, as conventional global players from the developed economies are also offering Islamic financial services. Non-Muslim countries such as Australia, China, France, Germany, Hong Kong, Italy, Japan, Korea, Luxembourg, Singapore and the United Kingdom have undertaken initiatives to introduce Islamic finance in their financial systems. This trend is expected to contribute towards greater cross-border flows in terms of increased trade and investment transactions, thereby strengthening economic linkages.2

According to an Oliver Wyman report,3 Islamic finance represents 1% of global financial assets. The industry has been growing at over 30% annually since 2000 and is set for continued strong growth. According to their estimation, Islamic assets will reach almost $1600 billion with revenues of $120 billion by 2012. Moody’s estimates the long-term outlook for Islamic finance as $5 trillion,4 based on a Muslim population of around 1.5 billion across the globe.

As the Islamic financial industry becomes an integral part of the financial system, there is a need to have in place a robust regulatory framework that adequately takes into account the unique characteristics of the Islamic banking business to ensure the soundness, stability and sustainability of the Islamic financial system. Such a regulatory framework needs to be comprehensive enough to provide a level playing field for the Islamic banking industry, especially in an environment where it runs parallel to its conventional counterpart. While the regulatory framework for conventional banking is aimed at ensuring the soundness and stability of the financial system, the Islamic banking framework has an added dimension of Sharī`ah, as non-compliance with the Sharī`ah could pose severe risks for the financial health and sustainability of institutions offering Islamic financial services (IIFS). The regulatory framework for IIFS should thus ensure: (a) that adequate risk management and Sharī`ah compliance systems are in place both at the individual institution and industry level; (b) transparency and adequacy of disclosures, enabling the depositors/investors to make well-informed decisions about doing banking with systems (conventional or Islamic) and institutions of their choice; and (c) that an efficient dispute resolution mechanism is in place to provide necessary comfort to both banks and their clientele. The dispute

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2 Islamic Finance and Global Financial Stability Report (April 2010), IFSB, IDB, IRTI.
4 www.reuters.com/article/idUSLDE65D19720100614.
resolution mechanism is particularly important during insolvency of the borrower/client or the banks/financial institutions.

Further, the recent trend of increasing assets of Islamic finance in the overall global financial system has significant implications for the existing insolvency regimes in place in various jurisdictions. It is therefore imperative that suitable amendments are incorporated in the conventional insolvency regime to bring more clarity in regard to the rights and obligations of the various parties to Islamic finance contracts. Moreover, cross-border insolvencies would remain a challenge even if the majority Muslim countries were to develop/modify their existing insolvency regimes in line with the principles of Shari’ah/Islamic finance, because of the variance of approaches adopted by each jurisdiction in line with its own requirements and legal structure. A model insolvency framework for Islamic finance transactions/institutions on the pattern of the UNCITRAL model legislation may help in bringing about standardisation and uniformity in insolvency laws at the international level.

This paper, being written on the invitation of the Islamic Financial Services Board (IFSB), is aimed at making an objective analysis of the resolution regime in place in Pakistan and its overall effectiveness in promoting investors’ confidence in the country’s Islamic financial system. The paper, which starts with a commentary on the Hamid Yunis’s Paper, also discusses the possible insolvencies and defaults of IIFS clients and potential issues in recovery of IIFS financing/investment with or without involving a court of law.

II. Comments on the Issues Paper on Insolvency Regimes

In the light of the recent global financial crisis and its serious impact on financial institutions, it is quite timely for the IFSB to initiate its project on the subject of “Effective Insolvency Regimes: Institutional, Regulatory and Legal Issues Relating to Islamic Finance”. The paper by Mr Hamid Yunis discusses some important dimensions of Islamic finance with reference to insolvency, ranging from handling of Islamic finance cases in courts of law, to contractual terms and conditions commonly incorporated in the transactions and related issues.

The paper provides a general overview of the stock of court cases related to Islamic finance, and of how a Shari’ah-compliant transaction could turn out to be vulnerable when challenged in a court of law, particularly in a secular legal system, which is the common situation in the majority of jurisdictions where Islamic finance is being practised. It also suggests that it would not be a simple matter to implement the terms of Islamic finance contracts in legal systems that are not in line with Shari’ah, primarily due to ambiguities in the terms of the contract.

The author has pertinently pointed out the issues concerning recognition of Shari’ah in a secular legal environment where Islamic financial transactions were challenged. It is rightly mentioned that clarity in drafting the terms of the contract is essential in order to uphold the position of the parties to the contract and remove recovery and foreclosure hurdles. It is thus advisable to examine the clarity of agreements in various jurisdictions. The regulatory bodies in those jurisdictions may initiate country-specific exercises to assess the quality of the contracts. In Pakistan, the State Bank of Pakistan (SBP) has issued detailed features (essentials) of Islamic modes of finance and model agreements for various Islamic finance products/modes, which facilitate understanding of the contracts by both the Islamic banks and the counterparts and are also referred to by the court of law in Pakistan.
Another important observation about the cases quoted in the paper is that they highlight the English courts’ responses/decisions, which were made on the basis of English law and did not recognise the *Sharī’ah* aspects of the agreements. It would have been more enlightening had cases from other countries, especially Muslim countries, also been considered in terms of whether or not *Sharī’ah* principles are recognised in those jurisdictions.

While providing a general overview of insolvency practices in different jurisdictions, the author has rightly pointed out the complexities in specific countries where *Sharī’ah* principles, or terms of the contracts in line with the *Sharī’ah*, may be set aside and a decision made as per the legal system, which is not supportive of the *Sharī’ah*. This necessitates that the authorities in those jurisdictions take steps to properly recognise Islamic finance practices in their legal system.

The author has focused exclusively on the insolvency of IIFS clients, and has not touched on the insolvencies of IIFS. While an effective insolvency regime for dealing with the insolvency of IIFS clients is extremely important for the future growth and development of Islamic finance, it would have been useful had the paper also covered the insolvency of IIFS, either through a real case study or a hypothetical case, as this is an area where significant gaps exist in the legal systems of various jurisdictions, including Pakistan. The grey areas in this respect include the status of IIFS depositors as creditors, shareholders or quasi-shareholders during the insolvency of IIFS, differentiation of current and savings deposits in legal terms, the priority of payment, if any, of current accounts during insolvency, the legal position of restricted and unrestricted deposits, interbank transactions and their underlying contracts, the treatment of charity funds and profit equalisation funds, and so on.

The author has identified a shortage of qualified *Sharī’ah* scholars and a lack of global consensus on *Sharī’ah* interpretation, especially in innovative products, as the main challenges facing the industry. While these are truly the key industry challenges, the capacity and understanding of Islamic finance by Islamic bankers, enterprises, lawyers, judges, regulators and policy-makers is also a major challenge faced by the industry.

The author has concluded his paper with the observation that exploration of insolvency issues has as yet merely scratched the surface. There are strong suggestions that Islamic finance does not harbour more risks than conventional financing methods, he notes, and the growth in *Sharī’ah*-compliant structures is a positive sign for consumer and investor confidence. The compatibility of an Islamic finance risk profile with that of conventional finance may, however, be attributed to the existing Islamic finance paradigm, which in most jurisdictions is the provision of conventional banking services through *Sharī’ah*-compliant structures and minimising the risk profile to put it on a par with that of conventional finance. While this may be positive for the investors, it may not enable the IIFS to harness the full potential of Islamic finance and offer itself as an appropriate alternative to conventional finance. This current Islamic banking paradigm could also be blamed for the courts’ reservations in various jurisdictions to give due weight to the *Sharī’ah* aspects of the contracts.
III. Legal, Regulatory and Shari‘ah Compliance Infrastructure in Pakistan

Efforts to establish an Islamic banking system in Pakistan started during the 1970s. Significant steps were undertaken in 1980 and 1984 to set up the regulatory structure to provide legal cover for Islamic banking practices in Pakistan.

In 1980, Participation Term Certificates (PTC), a corporate financing instrument based on profit and loss sharing, were introduced to replace interest-based debentures. A separate law, the \textit{Muḍārabah} Companies and \textit{Muḍārabah} (Floatation and Control) Ordinance 1980 (the “\textit{Muḍārabah} Ordinance”) was promulgated to provide for registration of \textit{Muḍārabah} companies and the floatation, management and regulation of \textit{Muḍārabah}. The \textit{Muḍārabah} Companies and \textit{Muḍārabah} Rules 1981 were also introduced, in terms of which \textit{Muḍārabah} was defined as a mode of business/financing. Moreover, the Code of Civil Procedure (Amendment) Ordinance 1980 was promulgated to set out procedures for the civil courts to estimate the rate of profit in the case of recovery of finances/loans granted on the basis of participation in profit and loss. (Previously, the courts were only authorised to order payment of interest on monies.) In addition to the above, the Banking Companies (Recovery of Loans) Ordinance 1979 was amended to extend the definition of loans and advances to include financing on a non-interest basis.

In pursuit of Islamising the financial system, profit- and loss-sharing (PLS) based accounts with SBP, and mark-up transactions with provincial and central government bodies, and with certain government-owned enterprises, were introduced. Further, nationalised banks were allowed to open interest-free deposit counters. To provide legal support for Islamic banking operations, enabling provisions were made in seven laws of Pakistan, including the State Bank of Pakistan Act 1956, the Banking Companies Ordinance 1962, the Bank (Nationalisation) Act 1974, the Banking Companies (Recoveries of Loans) Act 1979, the Negotiable Instrument Act 1881, the Limitation Act 1908, and the Code of Civil Procedures Act 1908.

Significant steps were taken to provide legal and regulatory support for Islamic banking operations with the promulgation of the Banking Tribunal Ordinance 1984, wherein the scope of business of both commercial and cooperative banks was enlarged to include the purchase and sale of property. In addition, 13 modes of finance based on Islamic finance principles were introduced in the banking system, and banks were advised not to charge a mark-up on the marked-up price. Also in 1984, the SBP issued a circular setting out detailed guidelines/instructions to eliminate \textit{Riba} from the banking system during the course of the 1984/1985 financial year. The key features of the legal and regulatory amendments introduced in Pakistan between 1980 and 1984 were as follows:

- The scope of the terms “creditor” and “debtor” was enhanced to accommodate Islamic modes of receiving deposits and extending financing, respectively.
- The definition of “loans and advances” was enhanced to include financing provided on the basis of participation in profit and loss, mark-up in price, leasing and hire-purchase.
- Banks were allowed to finance the sale, purchase or acquisition of any property, including commodities.
- Banks were allowed to accept deposits based on participation in the bank’s profit and loss.
- Banks accepting deposits on the basis of participation in their profit and loss were advised to:
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- maintain separate accounts in respect of PLS deposits, investments made, finances provided out of such deposits, cash and liquidity assets maintained there, as well as all income and expenditure relating to these deposits; and
- invest or employ such deposits, at the absolute discretion of the banking company, only in transactions or business from which income does not accrue by way of interest.

- The central bank was allowed to provide finance to scheduled banks and financial institutions on the basis of participation in profit and loss.
- Amendments to the Registration Act 1908 and the Stamps Act 1899 were made to authorise the government to exempt banks from registration costs and stamp duties on additional documentation on account of the transformation of interest-based finances to non-interest-based finances.

In addition to the above, legal support was made available through the promulgation of the Tribunals Ordinance 1984 for the recovery of finances provided by banks and financial institutions under an interest-free system. The ordinance supported the establishment of banking tribunals with all the powers of civil and criminal courts vested in them. All suits filed in a banking tribunal were required to be disposed of within 90 days of the filing of the case. The recovery procedure in the Tribunals Ordinance 1984 was intended to be even quicker than the summary procedure provided under the Banking Companies (Recovery of Loans) Ordinance 1979. Thus, emphasis was placed on the quick passing and execution of the decree.

The Federal Shari'ah Court was established in 1980 to ensure that all legislation in the country conforms to Islamic injunctions. The court has the power to examine and decide, either at its own motion or on the petition of any citizen of Pakistan, whether or not any law or provision of a law is repugnant to Islam. For example, in a famous judgment in 1991, the court declared that interest-free banking initiated in the 1980s was Riba-based and thus repugnant to Islamic injunctions. The decision was upheld by the Shari'ah Appellate Bench of the Supreme Court in December 1999; the Shari'ah Appellate Bench gave the government two years to transform the banking system into an Islamic banking system. However, the decision was set aside by the Shari'ah Appellate Bench (reconstituted bench) in 2002, which referred the case back to the Federal Shari'ah Court for a fresh hearing. The case is still pending in the Federal Shari'ah Court. Although presently not all that active, the decisions of the Federal Shari'ah Court may have wide-ranging implications for the country’s economic and financial system, including Islamic finance.

Having learned from its unsuccessful attempt in 1984 to transform the banking system into an Islamic system, and given the decision of the Shari'ah Appellate Bench of the Supreme Court referred to above, the SBP reintroduced Islamic banking in 2003 as a parallel and alternate system to conventional banking, so as to enable the public to adopt the banking system of their choice. It established a detailed regulatory and Shari'ah compliance framework, which allowed three types of Islamic banking institutions (IBIs) to be established and operate in the country, as follows:

- full-fledged Islamic banks;
- Islamic banks as subsidiaries of conventional banks; and
- stand-alone Islamic banking branches of conventional banks.

While the legal and regulatory frameworks for conventional banks were tailored/modified to extend their coverage to Islamic banks, the focus essentially remained on developing an effective Shari'ah compliance framework. The following are the main pillars of the SBP Shari'ah compliance framework:
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- establishment of an SBP Sharī'ah Board;
- appointment of a Sharī'ah adviser by the IBIs based on the SBP’s fit and proper criteria;
- issuance of the essentials and model agreements for Islamic modes of finance;
- adoption of AAOIFI Sharī'ah Standards;
- instructions and guidelines for Sharī'ah compliance in the Islamic banking industry;
- introduction of internal Sharī'ah audits at the IBI level; and
- inspections for Sharī'ah compliance by SBP inspection teams.

IV. Liquidation and Winding up of Banking Companies

This section discusses the key features of the legal framework available in Pakistan for dealing with cases related to liquidation and winding up of a banking company. The Banking Companies Ordinance (BCO) 1962 defines and prescribes a detailed mechanism for suspension of business and winding up of banking companies in Pakistan. The framework also defines the powers of the SBP, the federal government, the High Court, and so on, in regard to the liquidation and winding up of banking companies, and prescribes the mechanism for making payments to depositors and creditors (both secured and unsecured) in the event of liquidation and winding up. The depositors of banking companies have first right to the banks’ assets, while secured creditors have second right after the depositors are paid in full. Among the depositors, small depositors with deposits of up to 100,000 rupees are given priority; that is, small depositors will be paid in full first, followed by the remaining depositors. After payments to all the depositors are made in full, pro rata payments are made to every claimant entitled to preferential payments (i.e. secured creditors).

As Islamic banking companies in Pakistan have been licensed under a similar legal framework to conventional banks, the liquidation and winding-up provisions defined for conventional banks are also applicable to Islamic banks. However, there are some significant issues and grey areas in the liquidation of Islamic banks, including the treatment of different types of depositors, which are discussed below.

A. Status of PLS Depositors/Investment Account Holders

A significant proportion (presently around 70%) of the Islamic banks’ deposits comprise savings deposits mobilised under the Muḍārabah principle – that is, profit-sharing and loss-bearing accounts. As per the contractual arrangement, the depositors provide funds, which the Islamic banks deploy in various ways. Any profits are shared with the depositors as per the agreed profit-sharing ratio. In case of loss, the same is borne by the depositors unless it has been caused by the Islamic bank’s misconduct, negligence or breach of contract. Further, the deposits are deployed in various pools based on their tenor and size. However, the depositors generally have no information about the pools in which their deposits are deployed; the banks have total discretion in assigning the deposits to various pools. Based on the contractual arrangement, in the event of insolvency of an Islamic bank it will be difficult for the liquidator to assign the profits/losses earned/incurred by different pools to the depositors. As there have been no cases of insolvency of an Islamic bank so far, this important issue has not been given the attention it deserves both by banks and the regulators.

Further, the legal system does not support the PLS-based contractual relationship between depositors and Islamic banks, as Islamic deposits or investment accounts have not been defined separately in the law. The banking law in Pakistan
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treats all depositors, including those of Islamic banks, as creditors (with creditors having preferential rights over the assets of the bank in the event of liquidation); as such, the profit-sharing and loss-bearing clause in the contract may not be legally tenable and may give rise to legal disputes during winding-up proceedings. Similarly, current accounts, which are mobilised as Qarḍ and are not entitled/liable to for any profit/loss, stand on a par with the PLS and other savings deposits in legal terms and thus might complicate the insolvency proceedings further.

B. Liquidation of Financing Portfolio

Murābahaḥ – that is, sale on a deferred payment basis – is the most commonly used mode for extending Islamic finance and thus constitutes a major portion of an Islamic bank’s financing portfolio. In the event of liquidation of an Islamic banking institution, insolvency proceedings may suffer due to the non-liquidation of its debt-based portfolio, since – as per Shari‘ah principles – debt can only be assigned and cannot be sold at a discount or for a premium. Further, the amount under the Murābahaḥ agreement becomes due only after the period of time agreed between the parties. In the case of insolvency proceedings, the realisation of such assets may delay payment to the depositors and creditors, which may negatively impact the insolvency proceedings.

C. Parallel Banking System

In most jurisdictions, conventional banks are offering Islamic banking through windows or a dedicated Islamic branch network. Under this paradigm, a conventional bank has an interest-based portfolio, both on the assets and liabilities side, for its conventional banking operations and, at the same time, a Shari‘ah-compliant portfolio of assets and liabilities for its Islamic banking operations. Considering the peculiar nature of Islamic banking contracts, it is essential that the rights, obligations, payment priorities, etc., of each set/type of the bank’s customers (both conventional and Islamic) are explicitly defined and prescribed in the legal framework in case of insolvency of such bank. While the regulatory framework in most jurisdictions requires the creation of firewalls between the conventional and Islamic funds, portfolios, and so on, the existing insolvency framework lacks clarity on such issues.

D. Treatment of Profit Equalisation Reserves (PER)

To smoothe the profit-payouts to PLS depositors, Islamic banks normally create Profit Equalisation Reserves (PER), which are funded out of the income of depositors and that of the bank. When the profits generated by a certain pool of deposits exceed the expected rate of return, a certain portion of the profit is set aside in the PER and is utilised when the profit from the pool of deposits is below the expected rate of return. The PER policy should explicitly define the rights and obligations of each party with regard to PER, especially in the event of the bank’s insolvency. The absence of an explicit policy for treatment/utilisation of the PER may give rise to legal and Shari‘ah issues and thus could complicate the insolvency proceedings.

E. Charity Funds

Special attention would also be required to be paid to the legal status of a charity fund of IIFS in case of its insolvency. Generally, in jurisdictions where IIFS maintain/create charity funds (i.e. a fund/account into which is credited income received by the IIFS from non-Shari‘ah-compliant sources, penalties received from clients for delaying their payments, and so on), the amount available in the fund is utilised as per the policy of the institution or instructions provided by the regulator, as
the case may be. The utilisation varies from jurisdiction to jurisdiction and thus may complicate the insolvency proceedings. The legal and regulatory framework should therefore define explicitly define the treatment of the charity in the event of winding up of an IIFS.

V. Insolvency of IIFS Clients and Implications for the Financial Condition of IIFS

The insolvency regime for IIFS not only comprises an elaborate mechanism for resolution/liquidation of insolvent IIFS, but also the framework for dealing with insolvencies of IIFS’s clients. The IFSB issue paper on the insolvency regime focuses largely on the insolvencies of enterprises that obtained financing from IIFS. As discussed in earlier sections, necessary amendments to Pakistan’s banking laws, the Code of Civil Procedure, etc., to enable Islamic banks to recover finances from defaulting/insolvent clients. The Recovery of Finances Ordinance 2001 also provided a relatively speedy mechanism for recovery of banks’ non-performance financing. While the overall quality of Islamic banks’ financing portfolios have been better than their conventional counterparts, particularly following the financial crisis of 2007, a number of cases have been filed in the banking and superior courts, both by Islamic banks and their clients, for resolution of disputes and/or settlement/recovery of dues. In some of the cases, interesting Shariah-related pleas have been made by the clients, highlighting the peculiar risks being faced by Islamic banks. Some of the cases that have been decided in the courts in Pakistan, and others that are still being heard by the courts, are briefly discussed below. Where cases are still before the courts, the particulars of the parties are not disclosed.

A. Anwar Mansoor Judgment

In this famous judgment on rescheduling, restructuring and early settlement of debt (Murabahah sale/purchase price), the Sindh High Court gave the following verdict:^5

- Any addition on the purchase price (Murabahah price) agreed between the parties was not allowed, as once the price is fixed it cannot be changed. Immediately after the execution of sale, the price of the commodity becomes a debt (obligation) payable by the purchaser; and any increase in the debt is ‘Riba’ under Shariah.
- Once the principal debt (sale price) is determined, no mark-up by whatever name can be charged. Subsequent agreement(s) to settle the previous debt, or for renewal thereof, amounts to defeating the provisions of the specific law available, and thus shall be void. Such renewal of the contract is window dressing and all profits shown are nothing but added mark-up.
- A bank can only seek recovery of the marked-up price under the first agreement. However, in case the bank is able to establish that the amount has been actually disbursed under the subsequent agreement, and that it is not for adjusting the previous debts and that there has been a de facto sale and purchase in a commodity, the subsequent agreements entered into for such purposes independent of the previous agreements can be looked into and money could be recoverable there against. (This is reflective of the difficulties and complexities in rescheduling/restructuring of debt- (Murabahah-) based financing being undertaken by IIFS).

^5 A summarised verdict only is included in this paper.
B. Cases Presently Being Heard in Courts of Law

Below are the current cases presently under hearing in courts of law in Pakistan:

- Under a particular Murābahah-based transaction, the customer defaulted and failed to make the agreed instalment payments. The bank filed a recovery suit in the court, whereupon the customer requested additional time to make the payment, quoting a reference from the Holy Quran: “And if he (the debtor) is short of funds, then he must be given respite until he is well off. (2:280)” If the court is convinced that the debtor is actually in financial distress or short of funds, it may give some respite to the client. This may, however, have negative implications for Islamic banks, as no objective criteria are available to verify a client’s claim regarding financial difficulties and this may thus encourage other clients to seek similar relief.

- In another case, a customer entered into a “Diminishing Mushārakah cum ījārah” agreement with the bank, with lease (ījārah) rentals linked with the Karachi Interbank Offered Rate (KIBOR) as the reference benchmark. The customer subsequently defaulted on making rental payments, etc., and pleaded in the court that the contract be declared null and void as the rentals were based on an interest-based benchmark that does not conform to Shari`ah principles.

- In yet another case of “Diminishing Mushārakah cum ījārah”, a client who obtained financing from an Islamic bank to purchase a house in a middle-class area defaulted on making rental payments. The client pleaded in the court that:
  - the rent being charged by the bank was unrealistic, as it was about eight times the prevailing rent for a house in the area; and
  - according to the Investment Regulations 1979, the anticipated gross annual rental income of a house in which an investment is made shall be the average of the rents charged for similar houses in the area.

Such cases signify the need to bring more transparency and clarity to the contracts being used by IIFS to extend their various financing facilities. While the rentals based on KIBOR would normally be higher than the prevailing rentals in the real estate market, the capital gains, and so on, are all accrued to the clients. The contract should elaborate specifically on all such aspects to avoid unnecessary litigation, particularly in the presence of regulations such as the Investment Regulations 1979.

- In one case, a conventional bank sold a car to a customer on a Murābahah basis. The customer defaulted on the repayment of instalments and pleaded in the court that the Murābahah agreement executed between him and the bank does not conform to Islamic principles; hence, the same may be declared void. The case is still under the litigation. However, the scenario requires, inter alia, that an explicit regulatory framework shall be in place wherein only those banks that have been licensed to carry out Shari`ah-compliant business may offer such products and services – restricting conventional banks from using Islamic names in their product offerings.

The aforesaid cases/practices underscore the need to have the legal system fully integrated with the regulatory framework. Moreover, the underlying contract needs to be comprehensive enough to define adequately the rights and obligations of each party to the contract.
VI. Other Issues

Below are other issues that also need to be explored in order to provide adequate insolvency regimes for Islamic finance.

A. Risks Associated with Investments in Sukūk

Under *Ijārah* Sukūk transactions, it is important that the Sukūk certificate holders own the leased assets – not just a right to receive the rentals. Accordingly, the holders of Sukūk have to jointly bear the price risk and ownership-related costs and risks of the assets. This requires that the underlying assets are sold and registered in favour of the Sukūk issuer/investors. As most of the IIFS have quite significant investments in Sukūk, defaults and insolvency of the Sukūk issuer may have serious implications for the financial health of the IIFS. It is therefore desirable that the necessary mechanism is developed for establishing the ownership of the underlying asset by the Sukūk holders (mostly the IIFS) in the eyes of the legal system. This would not only provide the necessary recourse to the Sukūk holders in the event of defaults/insolvency of the Sukūk issuer, but would also significantly improve the Sharīʿah image of the Sukūk.

B. Tax Treatment in Insolvency of Clients and IIFS

The IIFS, due to their inherently different nature of business, deal in the sale/purchase/lease of real assets. On the other hand, the taxation laws for financial institutions have been developed with conventional banking and finance transactions in mind. The applicability of these conventional taxation laws adds more difficulty when there are cases of insolvency of clients and/or of the IIFS itself. The applicable taxation laws in Pakistan have not yet defined specific taxation treatment for cases involving the sale, purchase or liquidation of financing, investments and other assets/portfolios of IIFS in the event of insolvency. However, the Finance Act 2007 contains provisions that provide tax neutrality to Islamic banks vis-à-vis conventional banks in Pakistan. The tax neutrality provisions give comfort to investors/stakeholders by providing that, in the event of insolvency and liquidation of IIFS, the tax treatment applicable to the financing and investment portfolios of conventional banks would also be applicable to those of the IIFS. The IFSB’s initiative to start deliberations on the need for an effective insolvency regime is very timely and has been instrumental in sensitising the regulatory authorities about the importance of and urgent need for an effective insolvency regime for IIFS.

C. Liquidity Risk and Non-availability of LOLR: Implications for the Sustainability of IIFS

In most jurisdictions having Islamic finance, no – or only very limited – avenues are available to Islamic banks to manage their surplus liquidity and/or to access the central banks to obtain temporary/short-term liquidity. The current liquidity management framework of Islamic banks is based largely on interbank *Muḍārabah*, *Wakālah*, *Tawarruq* or Commodity *Murābahah*. However, that framework is neither efficient nor effective, and raises numerous Sharīʿah concerns in different jurisdictions, including Pakistan. Further, no Sharīʿah-compliant lender of last resort (LOLR) mechanism is available in most of the jurisdictions. Presently, most Islamic banks in Pakistan and various other countries are flush with liquidity, and thus the need for the LOLR has not been fully realised. Nevertheless, this is a major gap in the policy and regulatory environment for IIFS and may have serious implications for the sustainability of individual Islamic finance institutions as well as for the Islamic finance industry.
There is thus a need to develop a comprehensive Shari’ah-compliant liquidity management framework containing a LOLR mechanism, short-term liquidity management solutions and, especially, emergency financing operations whenever interbank liquidity comes under pressure.6

**D. Cross-border Insolvencies**

With the global integration of financial markets, there has been an enormous increase in the number of entities engaged in cross-border trade and finance transactions based on Shari’ah principles. It is therefore not unlikely that we will start to see more cross-border insolvency issues in the Islamic finance industry internationally. Various international initiatives have been taken to strengthen the insolvency regimes for conventional trade and commerce, and to improve coordination and cooperation among different jurisdictions to ensure the efficient and fair resolution of issues. It is desirable, therefore, to review, from an Islamic finance perspective, existing arrangements such as the UNCITRAL Model Law on Cross-Border Insolvency, the EU Bank Insolvency Directive, and regional treaties, codes, bilateral arrangements and other measures addressing insolvency of an entity/banking institution. Such a study will help in identifying the conflicts that may arise due to the application of Shari’ah principles and practices, and will also help to bring about convergence/consensus between the practices of insolvency regimes in various jurisdictions and the injunctions of Shari’ah. Since the scope of the task/work is very wide, the IFSB may also consider including institutions such as AAOIFI to leverage their extensive resource bases in developing standards for Islamic finance.

**VII. Conclusion and Recommendations**

The Islamic financial industry has achieved some significant milestones in terms of defining and strengthening the legal and regulatory framework in various jurisdictions. The industry, however, is still in an evolution phase, and so is the legal and regulatory framework. As the industry matures and moves to higher levels of growth and development, the legal and regulatory framework will need to be aligned to keep pace with the industry’s development. The rapid growth of the industry, particularly during the last decade, coupled with the recent financial crisis in the Western capital/financial markets, has significantly increased the need for a strengthened legal and regulatory framework in order to check the recurring crisis in the financial markets and deal effectively and efficiently with financial institutions experiencing financial distress. The IFSB’s initiative to discuss issues surrounding effective insolvency regime for IIFS is thus very timely and has provided an opportunity to the member countries to evaluate their respective legal and regulatory framework for IIFS and introduce necessary changes in the framework to foster investors’/depositors’ confidence in Islamic finance. The regulators/infrastructure institutions such as the IFSB may consider the following suggestions for developing an effective insolvency regime:

- The legal and regulatory framework for Islamic banking should be thoroughly reviewed and any necessary provisions incorporated to bring clarity in regard to the rights and obligations of counterparties, and particularly those of the depositors in the event of insolvency of IIFS.
- International Islamic Infrastructure institutions should take the lead in identifying relevant areas and suggesting possible solutions to bridge the gaps in the legal and regulatory framework.

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• The IFSB should also consider initiating a project to develop a model Sharī’ah-compliant insolvency regime along the lines of the UNCITRAL model legislation to bring about standardisation and uniformity of the insolvency laws at an international level.
• The disclosures, particularly in pool management and profit allocation/distribution, should be improved.
• The contract between Islamic banks and customers should be made more explicit and detailed to avoid any ambiguity.
• Legal practitioners should acquaint themselves with Islamic finance knowledge, and platforms where Islamic bankers and legal experts may interact in order to share knowledge should be developed/promoted.
• The regulatory bodies and Islamic bankers should collaborate to build the capacity of the legal fraternity in Islamic finance.
CHAPTER THREE: COMMENTARY PAPERS BY CENTRAL BANKS

COMMENTARY TWO

INSOLVENCY REGIMES OF THE ISLAMIC BANKING INDUSTRY: THE INDONESIAN EXPERIENCE

Dr Dadang Muljawan

I. Introduction

This chapter is intended to give an overview of the Indonesian Islamic banking operations as a sharing of experiences in the analysis of development of a resolution and insolvency regime for Islamic banks and Islamic transactions. Indonesia has put in place an insolvency framework within its current legal framework. However, while Indonesia has had some experience in arbitration and settlement of disputes in Islamic finance, it has not faced any solvency issues among its Islamic financial institutions, and hence it has not as yet experienced any dealings with insolvency issues.

In understanding the insolvency arrangements in Indonesia, it is important to understand the operations of the Indonesian Islamic finance industry and its business model. The following sections will provide extensive discussion on these issues before analysing the legal framework and insolvency regimes that guide Islamic financial services industry in the country.

II. Background on Islamic Finance Operations in Indonesia

Islamic banking in Indonesia was initiated well before the formal legal foundation was put in place. Led by a number of leading universities, some cooperatives offering Islamic saving and financing activities have been operating since the early 1980s. The first Islamic bank started operations only in 1992. The first Islamic bank was followed by the first Takāfūl operator in 1994. The Islamic bank operates under the Banking Act No. 7 of 1992, which implicitly recognised the Shari‘ah-based financial operations. The Islamic finance market was then supported by money market instruments to allow the Islamic bank to manage its liquidity more efficiently. On the capital market front, the first corporate Sukūk was issued in early 2002, which was followed by a substantial number of corporate Sukūk issuances in the following years. The significance of the development of the Islamic capital market was recognised with its inclusion in the national masterplan in 2005.

The basic principle of Islamic banking operations in Indonesia is the value of partnership and mutual benefit. Islamic banking in Indonesia is an alternative banking system with mutual benefits for the public and the bank. It refers to the banking system presenting applicable forms of Islamic concepts that are wisely formulated to address the current context of demand for alternative financial services in Indonesia within the consciousness of the historically influenced socio-cultural conditions of the country. This system gives priority to aspects related to fairness in transactions and ethical investment by underlining the value of togetherness and partnership in production and by avoiding any speculative activity in financial transactions. By providing various

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1 Dr Dadang Muljawan is an economic researcher with Bank Indonesia
products and banking services which are Shari’ah-based, Islamic banking is intended to be a credible alternative that can benefit all people without exception.

While Islamic banking came fairly late to Indonesia, it is envisioned by the authorities that the industry will be developed in such a way as to become a model for the Islamic banking industry, with open and universal characteristics. It is hoped that people throughout the whole of Indonesia will recognise and accept Islamic banking as part of the solution to a range of financial sector issues facing the economy.

Bank Indonesia aspires to develop the Islamic banking sector as part of its programme to promote sustainable economic development and social prosperity. Within the overall policy of promoting a market-based system with prudent banking practices, Indonesia encourages Islamic banks to enhance their financial performance and improve their efficiency while remaining compliant with Shari’ah principles. The Islamic banking sector has the opportunity to grow rapidly throughout the country, since it provides alternative financial instruments to the economy and Shari’ah-compliant products to the largest Muslim population in the world. The Islamic banking sector has grown at a compound annual growth rate of 32% in the last five years, with total assets of USD8.7 billion. It is expected to acquire a significant share of the national banking system by 2015.

The Sukūk market is also expanding rapidly. As at December 2009, a total of 28 corporate Islamic bonds (Sukūk) had been issued under Mudārakah and Ijārah contracts. The total value of issuances was IDR9.78 trillion (USD1.1 billion), or approximately 2.9% of the total value of bond issuances in the combined conventional and Islamic bond market. There were 36 Islamic mutual funds, consisting of equity funds, fixed-income funds and balanced funds. The total net asset value (NAV) was IDR1.8 trillion (USD163.64 million), approximately 3.5% of the NAV of all mutual funds.

In 2008, the Islamic Banking Act No. 21 of 2008 and the Shari’ah-based Government Bonds Act No. 19 of 2008 were ratified, providing a more flexible legal environment to further develop the Islamic banking industry, and more alternatives to the government to finance development projects through Shari’ah-compliant financing instruments.

Despite the economic downturn from the adverse effect of the recent global financial crisis, the soundness of the Indonesian Islamic banking industry has been maintained. Some contributing factors that are expected to significantly help the industry sustain its growth are as follows: (i) the enactment of the tax law No. 42 of 2009 to introduce the Value Added Tax, which became effective on April 1, 2010; (ii) the upgrade of Indonesia’s sovereign rating, reflecting the significant improvements in indicators on doing business and investing in Indonesia; (iii) the economic growth rate, which has successfully been maintained at high levels; and (iv) the expected global economic recovery.
The national Islamic banking institutions have so far been successful in performing their intermediation role. The financing to deposit ratio (FDR) has been maintained at a high level of around 95–100% (see Figure 1), suggesting that the Islamic banking industry has been effective in mobilising savings for investments and contributing to sustaining economic activities. The national Islamic banking industry has been most active in the provision of finance in the areas of electricity, mining and transportation (see Figure 2).

From only half-a-billion dollars of financing in 2001, total financing by Islamic banks has reached more than USD9 billion currently, and authorities expect that this financing will expand further to 5% of the asset share in the near future.

As seen from the graphs, the rate of development, or the growth rate, of the Islamic banking industry is about 13–14% on a year-on-year-basis. Given the growth potential and its impact on the Indonesian financial sector, there is a growing view that Bank Indonesia should put in place legal and risk management frameworks that underpin anticipatory actions to minimise the potential systemic risk.

The financial performance of Islamic banking institutions has been stable and robust, as indicated by the high profitability (return on assets, or ROA, of around 1.5%) and the low level of non-performing assets (net), which has been maintained below 4% in the last five years (see Figure 3). While the Islamic finance industry is being actively promoted by the national authorities, it is also in a vulnerable position. It faces adverse
CHAPTER THREE: COMMENTARY PAPERS BY CENTRAL BANKS

selection problems, as opportunists who want to take advantage of the expansion period may adopt less stringent prudential measures. However, the banking authority has been successful in putting in place the necessary regulatory actions to minimise this unintended consequence. The regulatory actions include the Islamic bank supervisory improvement programme, policy discussions with other governmental agencies, such as the tax office, to provide a more conducive playing field, strengthening the industrial capital base, and improving efficiency through financial deepening.

**Figure 3: Financial Performance of the Industry**

![Financial Performance Chart]

The supervisory improvement programmes cover infrastructure development relating to the supervisory system (implementation of information technology and methodology for risk-based supervision) and the development of human capital in understanding Islamic principles and prudential regulations simultaneously.

III. Business Activities of Islamic Banks

The risks facing Islamic banks depend mainly on the activities undertaken by the Islamic banks and on the complexity of the products offered. The higher the complexity of the products, the higher the complexity of the risks faced by the banks. Table 1 lists the Islamic banking products offered, with details of their contract base and inherent risk.

Table 2 lists the services offered by the Islamic banks that are also offered by other banking institutions. Those services include transfer payments, safe deposit boxes, bank guarantees, and letters of credit (local and domestic). Types of products that might differentiate Islamic banks from others are pawn services and factoring. The Islamic contingencies, as well as conventional ones (such as letters of credit and bank guarantees), possess a financing dimension that could turn into a credit risk when realised.
Table 1: Deposit Funds

<table>
<thead>
<tr>
<th>No.</th>
<th>Products</th>
<th>Types of Shari’ah contracts</th>
<th>Product classifications</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Current account USD</td>
<td>Wadi’ah</td>
<td>Current Accounts</td>
</tr>
<tr>
<td>2</td>
<td>Current account IDR</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>General saving</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Saving for Hajj</td>
<td>Muḍārabah</td>
<td>Savings</td>
</tr>
<tr>
<td>5</td>
<td>Saving for Hajj</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Gold saving</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Saving for family planner</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Saving for education</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Savings for the planner</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Savings for family</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Saving for religious tour</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>General savings</td>
<td></td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>National savings scheme</td>
<td>Muḍārabah Mutlaqah</td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>Saving for children</td>
<td>Muḍārabah</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Multiple use saving</td>
<td></td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>Time deposits</td>
<td>Muḍārabah Muqayyadah</td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>Special investment</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Table 2: Line of Services Offered

<table>
<thead>
<tr>
<th>No.</th>
<th>Products</th>
<th>Types of Shari’ah contracts</th>
<th>Product classifications</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>International transfers</td>
<td>Ijārah</td>
<td>Services</td>
</tr>
<tr>
<td>2</td>
<td>Bank guarantee</td>
<td>Kafālah</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Local letters of credit (L/C)</td>
<td>Kafālah, Wakālah bil ujrah</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Syariah card</td>
<td>Kafālah, Qard, Ijārah</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Safe deposit box</td>
<td>Qard, Ijārah</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Factoring</td>
<td>Qard, Murābahah</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Money changer</td>
<td>Sharf</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Money transfer</td>
<td>Wakālah</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Money transfer in forex</td>
<td>Wakālah</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Bancassurance</td>
<td>Wakālah bil ujrah</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>L/C export</td>
<td>Wakālah bil ujrah, Bay’, Kafālah</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>L/C import</td>
<td>Wakālah Kafālah</td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Pawn</td>
<td>Qard, Ijārah</td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>Gold pawn</td>
<td>Qard, Rahn, Ijārah</td>
<td></td>
</tr>
</tbody>
</table>

Table 3 shows Islamic banking products on the assets side, particularly non-sharing products. There are various kinds of Shari’ah modes of contracts underlying the transactions with the customers covering: Ijārah, Ijārah wal Wakālah, IMBT, Istinā’, parallel Istinā’, Salām, Murābahah, and a combination of Kafālah, Qard, Ijārah and Wadi’ah.
### Table 3: Non-investment Financing Products

<table>
<thead>
<tr>
<th>No.</th>
<th>Products</th>
<th>Types of Shari‘ah contracts</th>
<th>Product classification</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>General financing</td>
<td></td>
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<tr>
<td>2</td>
<td>Multi-use financing</td>
<td></td>
<td></td>
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<tr>
<td>3</td>
<td>Financing for education</td>
<td></td>
<td></td>
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<tr>
<td>4</td>
<td>Financing for medium enterprises and corporates</td>
<td>Ijārah</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Financing for small and medium enterprises</td>
<td></td>
<td></td>
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<tr>
<td>6</td>
<td>Working capital financing</td>
<td></td>
<td></td>
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<tr>
<td>7</td>
<td>Mortgage financing</td>
<td></td>
<td></td>
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<tr>
<td>8</td>
<td>Pilgrimage financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Pembiayaan multiyasas</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Trade financing</td>
<td>Ijārah wal Wakālah</td>
<td>Trade-based financing</td>
</tr>
<tr>
<td>11</td>
<td>General financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Equipment rental financing</td>
<td>IMBT</td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Channelling</td>
<td></td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>General financing</td>
<td>Istinā‘</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Mortgage financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>General financing</td>
<td>Parallel Istinā‘</td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>Mortgage financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>Residential financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>19</td>
<td>General financing</td>
<td>Salām</td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>General financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>21</td>
<td>Residential development financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>22</td>
<td>Consumptive financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>23</td>
<td>Corporate financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>24</td>
<td>Financing for micro and small enterprises</td>
<td>Murābahah</td>
<td></td>
</tr>
<tr>
<td>25</td>
<td>Working capital financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>26</td>
<td>Channelling</td>
<td></td>
<td></td>
</tr>
<tr>
<td>27</td>
<td>Consumer financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>28</td>
<td>Mortgage financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>29</td>
<td>Multi-purpose financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>30</td>
<td>Syariah card</td>
<td>Kafālah, Qard, Ijārah, Wadā‘ah</td>
<td></td>
</tr>
</tbody>
</table>

These products are generally used for consumptive financing such as mortgage financing, cars, and other basic needs such as health and education, among others. Some of them can also be used to finance the production sector by providing facilities in terms of capital financing for micro, small and medium enterprises, as well as corporates. Since the transactions are based on trading, the facilities can be categorised as fixed-income instruments that put profit margin and rental fees as the basis of profit earned by the banks. The use of the Shari‘ah contract in a single form as well as the combined version is meant to provide more flexibility in accommodating the variable cash flows of customers.

Islamic banks also have investment-based financing, as illustrated in Table 4. The transactions are based on Wakālah, Mushārakah, Muḍārabah Muqayyadah, Murābahah Ijārah and Qard. The implementation of Muḍārabah and Mushārakah contracts in Indonesia is based on revenue sharing, instead of profit and loss sharing. To equip themselves further, Islamic banks may also hold a credit enhancement which can be executed in the event of negligence. Normally, the Islamic bank would have the full right to execute the collateral if customers fail to fulfil their financial obligations as agreed by the contracting parties. However, potential disputes may still arise in the
area of Shari'ah interpretation in determining the terms of negligence or normal business loss.

Table 4: Investment-based Financing

<table>
<thead>
<tr>
<th>No.</th>
<th>Products</th>
<th>Types of Shari'ah contracts</th>
<th>Product classification</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Gold investment</td>
<td>Wakalah</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>General financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Revolving financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Corporate financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Financing for micro and small enterprises</td>
<td>Musharakah</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Standing facilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Syndicated financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>General financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Corporate financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Financing for micro and small enterprises</td>
<td>Mudarabah</td>
<td>Investation</td>
</tr>
<tr>
<td>11</td>
<td>Working capital financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Medium-term financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Channelling</td>
<td>Mudarabah Muqayyadah</td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>Executing financing</td>
<td>Mudarakah Mu'tanaqsiyah</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Musharakah Mutanaqsiyah</td>
<td>Mudarakah Mu'tanaqsiyah</td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>Financing from many to one</td>
<td>Mudarakah Muqayyadah</td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>Musharakah in USD</td>
<td>Musharakah</td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>Financing for pensioners</td>
<td>Murabaha, Ijarah</td>
<td></td>
</tr>
<tr>
<td>19</td>
<td>General financing</td>
<td>Qard</td>
<td></td>
</tr>
</tbody>
</table>

The IFSB’s Standard on Risk Management classifies the risks faced by Islamic banks into six main risks that include credit risk, equity investment risk, market risk, liquidity risk, rate of return and operational risk. The most crucial part is when Islamic banks as well as the authority need to make a building block that describes the actual flows of cash and potential loss experienced by the Islamic banks. The equity investment risk is borne by the sharing-based instruments that generate some level of uncertainty in the return, since the actual return is determined ex-post. Rate of return risk reflects the potential loss resulting from the rate differential between the market rate and the rate offered by the bank when the bank wants to retain customers by offering them higher returns.

IV. The Building Blocks of Business Activities

When setting up building blocks, the industry needs an adequate Islamic finance accounting standard that can translate the Shari'ah transactional standards into accounting treatments that clearly set the transactional arrangements between the contracting parties and take into account the local legal system. The Indonesian Islamic banking system adopts the Islamic accounting standard which has been dedicatedly developed, referring to the International Accounting Standard, AAOIFI and the existing conventional counterpart. Henceforth, this Indonesian Islamic accounting standard serves as the adapter of Shari'ah principles applied to the local system so that the enforcebility of the standards can be maintained and the potential dispute minimised. In addition, Shari'ah Fatwa is not legally enforced. Compliance with the Shari'ah principles is achieved through financial standards and regulatory standards that have been developed in accordance with the Shari'ah principles.
A. Features of the Liabilities Side

As reviewed earlier, in the paradigm version of Islamic banking, all the depositors should place their funds in profit sharing investment account (PSIA). The value of liabilities is always equal to the value of the assets, since the depositors put their funds in equity-based investments. Therefore, structurally, the paradigm versions of Islamic banks do not need a financial cushion. From the capital composition’s point of view, Islamic banks can be equated with the open-ended mutual funds companies. There is merit in the argument that Islamic banks in such cases are not under pressure to stabilise the periodic disbursements to account holders. However, the bank must declare the net asset value (NAV) of these funds at frequent intervals to enable investors to continuously monitor the performance of the bank. A rational investor should not expect a stable income unless the asset composition of the bank is predominantly in non-PLS products. Errico and Farahbaksh (1998) state that the ability of Islamic banks to reduce the capital value of investment deposits, in an excessive sense, could introduce strong incentives for moral hazard that could result in systemic risk. Islamic banks should provide more sophisticated schemes that give more protection to depositors’ funds in order to gain public confidence and, finally, to improve the robustness of the banking system. There are at least two key factors in an Islamic environment to help prevent the corrosive effect of problem assets on the level of capital. First, Islamic banks should have a more developed concept of the adequacy of valuation reserves. It is argued that a case of a loss should not be viewed as an automatic setting aside of provisions against loan losses. Second, Islamic banks should have an ability to administer and collect their loans effectively.

In current practice, Islamic banks’ activities diverge from the paradigm version in several ways. Some Islamic banks explicitly or implicitly guarantee all deposits, including investment deposits. Some Islamic banks give a guarantee on the expected rate of return on saving deposits. These financial guarantees are given to make Islamic banks more competitive in the global market, although, conceptually, it is not in accordance with the Shari’ah rules. In the Western environment, risk-averse depositors (households) place their funds in debt liabilities rather than in the financial intermediaries’ stocks since they want to limit the risk to the assets and maximise liquidity. The depositors are not supplied with sufficient information to evaluate the real value of claims held by the banks. Western banks have to be able to fulfil their financial obligations, which are fixed, while managing risky assets, which are fluctuating in value. Hence, the existence of bank capital is the consequence of the nature of the contract. This is the reason why minimum capital ratios have become a key part of current prudential regulations in Islamic banks.

Current Islamic banking practices provide various schemes of investments to fulfil the different needs of depositors. As reviewed in the previous chapter, there are three major types of depositors’ funds: (a) non-investment deposits; (b) restricted investment deposits; and (c) unrestricted investment deposits. Different deposit schemes can be viewed as a contract menu provided for different types of depositors. Depositors might have opportunities to compose their portfolio of deposits according to their own needs. An investor may need a portfolio investment that comprises different levels of risks at the same time. Risk-neutral depositors will choose a higher proportion of risky assets, while risk-averse depositors will prefer a higher proportion of riskless assets.2

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2 The model relates an individual’s utility function to the minimum risk premium required to induce full investment in the risky assets. The higher the level of risk aversion, the higher the risk premium required to induce full investments in the risky assets (see Huang and Litzenberger, 1992).
1) Non-investment Depositors (SA)

Non-investment depositors are risk-averse investors who are not willing to participate in the uncertainty of business. Although there is no fixed return required, a principal amount guarantee resembles a debt-based liabilities system and hence they need a sound repayment capacity of the bank at the time they want to liquidate their assets.

2) Unrestricted Investment Depositors (PSIA)

Unrestricted investment depositors exhibit a higher level of risk-taking behaviour since they are willing to take part in the uncertainty of business; therefore, they will face the possibility of profits and losses. The position of these depositors and the banks involves principal–agent relationships dealing in PLS contracts. On behalf of shareholders, managers are contracted to carry out business activities. Once they have agreed upon the contract (signed by both parties), the bank will carry out business actions.

3) Restricted Investment Depositors (PSIR)

Restricted investment depositors can be considered as sophisticated investors since they are involved in making investment decisions. Islamic banks, in this case, act as investment administrators; therefore, all responsibility for any loss should fall on depositors. For this reason, the AAOIFI suggests that restricted investment deposits are not included in the Islamic banks’ balance sheets. Restricted-investment depositors only need administrative and information services that allow them to assess their investment performance clearly. Islamic banks normally charge fees for delivering these informational and administrative services. Therefore, there is no need to apply any regulation since restricted investment depositors are fully informed and realise the risks they are running as a result of their investment decisions; the financial regulators’ objective should be to protect only unsophisticated (assumed less informed) and dispersed depositors.

4) Shareholders

The shareholders of Islamic banks receive their monetary surplus from profit shared. If the bank earns profits, the shareholder will obtain a profit share and an additional profit share as a management fee. If the bank generates losses, the shareholders and unrestricted investment depositors will share the losses. The shareholders in this event are not entitled to any additional monetary surplus for a reward for managing the unrestricted depositors’ funds.
The income streams for shareholders, depositors and savings account holders, as a result of business activities, are illustrated in Figure 4. \( p_{EC}, p_{PSIA} \) and \( p_f \) define income for shareholders, unrestricted investment depositors, saving depositors and extra monetary surplus for shareholders if the bank earns substantial profit. The net earning gained by the bank \( x \) gives different income \( (\pi_{EC}, \pi_{PSIA} \) and \( \pi_{SA}) \) for shareholders, unrestricted investment depositors and saving depositors, respectively. If the bank generates losses, the shareholders and the unrestricted investment depositors will share the losses \( \frac{p_{EC}}{p_{EC} + p_{PSIA}} \) and \( \frac{p_{PSIA}}{p_{EC} + p_{PSIA}} \) respectively. Profits earned will be shared among shareholders, unrestricted investment depositors and saving accounts/current account depositors. The shareholders will also enjoy an extra profit share \( (p_f) \) as a reward for infinite equity participation,\(^3\) therefore, shareholders will get a profit share proportional to their financial participation and the monetary surplus earned by the bank from the management fee.

The profit shares for shareholders, unrestricted investment depositors and savings/current accounts depositors are

\[
\frac{p_f + p_{EC}}{p_f + p_{EC} + p_{PSIA} + p_{SA}},
\]

\[
\frac{p_{PSIA}}{p_f + p_{EC} + p_{PSIA} + p_{SA}} \text{ and } \frac{p_{SA}}{p_f + p_{EC} + p_{PSIA} + p_{SA}}
\]

respectively. A summary of the financial characteristics of the liabilities side of an Islamic bank is given in Table 5. Generally, the financial products on the liabilities side can be divided into two types of claims: fixed claims and variable claims. The fixed type of claim consists of the fixed part of saving accounts \( (SA^{FC}) \). The variable types of claim consist of equity capital \( (EC) \), variable parts of saving accounts \( (SA^{VC}) \), and unrestricted investment deposits \( (PSIA^{V}) \). The building block for the liabilities side of an Islamic bank is illustrated in Table 6.

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3 Unrestricted investment depositors and an Islamic bank can be viewed as a principal and an agent that engage in a contract to conduct business activities. An agent is entitled to have a share of profit as a fee for managing the principal’s fund. In this case, the shareholders of an Islamic bank are entitled to enjoy a monetary surplus from management fees as a reward for managing the depositors’ funds.
Table 5: Payback Guarantee and Incentives for Islamic Bank Investors

<table>
<thead>
<tr>
<th>Source of bank funds</th>
<th>Payback guarantee</th>
<th>Type of depositors</th>
<th>Role in investment decision</th>
<th>Incentives for investors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owners’ equity (EC)</td>
<td>Like in a conventional bank, owners’ equity is not guaranteed.</td>
<td>–</td>
<td>High</td>
<td>Dividend</td>
</tr>
<tr>
<td>Non-investment deposits (SA)</td>
<td>Deposit is repayable in full. To guarantee the repayment, the deposit is backed by owners’ equity.</td>
<td>Unsophisticated and risk averse</td>
<td>None</td>
<td>Bonus</td>
</tr>
<tr>
<td>Investment deposits (PSIA)</td>
<td>Restricted</td>
<td>Sophisticated and risk taking</td>
<td>High</td>
<td>Profit share that is earned from individual projects</td>
</tr>
<tr>
<td>Unrestricted (PSIA)</td>
<td>The bank is not obligated in case of loss to return the original amount of funds received from the account holders unless the loss is due to negligence or breach of contract.</td>
<td>Unsophisticated and moderately risk taking</td>
<td>None</td>
<td>Profit share from total investment of the bank</td>
</tr>
</tbody>
</table>

Table 6: The Building Blocks of the Liabilities Side

<table>
<thead>
<tr>
<th>Products</th>
<th>Fixed claims</th>
<th>Variable claims</th>
</tr>
</thead>
<tbody>
<tr>
<td>SA EC</td>
<td>Fixed</td>
<td>–</td>
</tr>
<tr>
<td>SA EC, PSIA EC, EC</td>
<td>Undetermined</td>
<td>Fixed</td>
</tr>
</tbody>
</table>

B. Features of the Assets Side

Islamic banks have two general types of loan portfolio: (a) a sharing-based loan portfolio; and (b) a non-sharing-based loan portfolio. The sharing-based contract is encouraged to improve long-term partnership between lenders and borrowers, while the non-sharing-based contract is used to meet practical demands (short-term contracts). Table 7 shows the characteristics that distinguish sharing-based assets from non-sharing-based assets.

Table 7: Distinguishing Characteristics of Sharing-based Assets

<table>
<thead>
<tr>
<th>Determination of monetary rewards</th>
<th>Sharing-based assets</th>
<th>Non-sharing-based assets</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Sharing rate of monetary surplus is determined ex-ante. Monetary reward is determined ex-post.</td>
<td>Monetary reward is determined ex-ante.</td>
</tr>
<tr>
<td>Objectives</td>
<td>Emphasise the partnership between the lender and the</td>
<td>Emphasise the practicality when sharing schemes cannot</td>
</tr>
</tbody>
</table>
CHAPTER THREE: COMMENTARY PAPERS BY CENTRAL BANKS

The financial products of an Islamic bank can be classified into three general types of claim: (a) fixed claims in terms of final value; (b) fixed claims in terms of inventories; and (c) variable claims. There are several products that can be classified into the first category – that is, Murābahah/mark-up (MR), Bay’ Bithamin Ąjili/deferred sale (BBA), Ḥirārah/leasing (IJ), the fixed part of a hybrid contract (SH\text{\text{FC}}\text{\text{Hybs}}), and the fixed part of a Qarḍ al-Hassan/benevolent loan (QH\text{\text{FC}}). The values of the second types of claims depend upon market variables. The real values of the products can be known through a marked-to-market process. The products include Salām/agricultural product financing (SA), Iṣlān/ project financing in manufacturing (ISH), and al-Dayn/foreign-exchange trading (DA). The values of the third types of claim fully depend upon the real productivity of the entrepreneurs. The products include the variable parts of sharing products (SH\text{\text{FC}}\text{\text{Hybs}}) and full sharing products (SH). The general building block of financial products on the assets side is illustrated in Table 8.

<table>
<thead>
<tr>
<th>Products</th>
<th>Fixed claims</th>
<th>Variable claims</th>
</tr>
</thead>
<tbody>
<tr>
<td>In terms of final values</td>
<td>In terms of inventories</td>
<td></td>
</tr>
<tr>
<td>(MR) (BBA) (IJ)</td>
<td>Fixed</td>
<td>–</td>
</tr>
<tr>
<td>(SH\text{\text{FC}}\text{\text{Hybs}}) (QH\text{\text{FC}})</td>
<td>–</td>
<td></td>
</tr>
<tr>
<td>(SA) (ISH) (DA)</td>
<td>Marked to market</td>
<td>Fixed</td>
</tr>
<tr>
<td>(SH\text{\text{FC}}\text{\text{Hybs}}) (SH)</td>
<td>Marked to market</td>
<td>Depends upon the level of productivity</td>
</tr>
</tbody>
</table>

C. Contractual Arrangements within an Islamic Bank

An Islamic bank uses various types of financial contracts. Figure 5, section (a) shows three types of deposits on the liabilities side of an Islamic bank: non-investment deposits (SA); unrestricted profit-sharing investment deposits (UPSIA); and restricted profit-sharing investment deposits (RPSIA).
Islamic banks guarantee the principal amount of deposits and share any monetary surplus with the SA, whilst they share the profit or losses with the UPSIA. Islamic banks provide only administrative services to the RPSIA since the depositors are themselves actively involved in investment decision making. This demonstrates that Islamic banks perform fiduciary and agency roles at the same time. Islamic banks should maintain their repayment capabilities for the risk-averse depositors, and deliver the highest monetary return possible to the risk-taking investors. However, the proportion of UPSIA to total assets varies depending upon the preferences of the investors; the higher the proportion of UPSIA, the more significant the agency role undertaken (i.e. the UPSIA give full authorisation to the bank to take all decisions relating to the investment process). On the contrary, the higher the proportion of SA, the more significant the fiduciary role undertaken (i.e. the bank should strive to maintain the value of the SA first and foremost). The capital regulations for Islamic banks should be capable of enhancing the fiduciary roles performed for risk-averse depositors, and the agency roles performed for risk-taking investors.

Figure 5, section (b) shows various types of investment on the assets side of an Islamic bank. These investments can be classified into PLS- and non-PLS-based investments. Mudarabah and Musharakah modes of financing can be classified as PLS-based investments [PLSI], while Murabahah, Ijara and Salam can be classified as non-PLS-based investments [MUI-denoting 'mark-up'-based investments]. In practice, there also exist hybrid types of investment [HYB] that combine the two basic modes of finance. [Some part of the claim is fixed and some part is variable – for example, lending money with a guarantee on the repayment of principal but also sharing the profits.] Individual Islamic banks select their preferred compositions of assets. [For further information on the variety of permissible Islamic investments, see Haron and Shanmugam, 1997; Errico and Farahbaksh, 1998; and Haron, 1998.]

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4 The SA depositors have the right to determine the investment types chosen. The banks merely provide them with information about feasible investments. Therefore, the SA depositors take responsibility for investment risk.
Figure 5, section (c) shows the pivotal position of the banking regulator, who is trying to ensure the sustainability of the savings/investment process. The regulations implemented should be able to provide the right incentives and protection for all market players to induce them to behave prudently. Besides designing a proper set of financial ratios for capital regulation, the regulators of Islamic banks should also consider adopting the second and third pillars of the Basel Committee’s new capital accord to empower the supervisory process and to improve transparency in the banking system.

A financial cushion is required by an Islamic bank to absorb financial losses. An Islamic bank with a high proportion of $A$ needs a high financial cushion to underpin its operations. For unrestricted investment depositors, equity capital can be viewed as a financial participation in a PLS contract that may give an incentive to the shareholders to more actively monitor the activities of the bank. A possible regulatory framework designed for the capital adequacy assessment of Islamic banks is summarised in Figure 6. Summing up the discussion in this section, it is concluded that a well-defined Shari‘ah-compliant accounting system that is enforceable legally will minimise potential disputes and provide an efficient and reliable Islamic banking system to the public. At the micro level, this will help the authority apply an effective micro prudential standard, including capital adequacy requirement and an effective risk-based supervision. The clearer the contract financially, the easier it is for the supervisor to determine the net worth of the Islamic bank. At the macro level, an accurate estimate of the net worth of Islamic banks will help the banking authority determine the thresholds of the systemic cost resulting from the potential operational failures of Islamic banking institutionally as well as systemically. These macro-prudential measures relate to the determination of an appropriate systemic insurance level, entry–exit policy and optimal stopping time to the Islamic banking industry.

**Figure 6: Possible Regulatory Approach Based on Characteristics of Deposits**

- **Debt based depositors**
  - Repayment assurance for debt based liabilities
  - Financial buffer
  - Monetary incentive in the principal-agent relationship
  - Covenant reporting

- **Unrestricted investment depositors**
  - Reducing moral hazard
  - Sufficient equity participation/capital

- **Restricted investment depositors**
  - Reducing asymmetric information

**V. Legal Framework for Islamic Finance in Indonesia**

The Islamic banking industry in Indonesia operates under several pieces of legislation, the main one being the Islamic Banking Act 2008. Prior to the enactment of this Act, the legal basis for the existence of Islamic banks in Indonesia was the Banking Act 1992. However, the latter Act was silent on the application of the Shari‘ah principles in deposit and financing practices by the banking sector. The ratification of the Islamic Banking Act provided a clear and stronger legal framework for the authorities to set up the regulatory framework for Islamic finance. Together with the
Indonesian Banking Act, the Central Banking Act, the Tax Law and Government Sukūk Law, the legislation governs the regulations underpinning operations of the Indonesian Islamic financial industry. The new tax regulations allowed a level playing field for all Islamic financial institutions, enabling them to avoid double taxation in transactions. The Government Sukūk Act allows the government to issue Shari’ah-compliant securities and bonds, broadly referred to as Sukūk.

The Islamic Banking Act 2008 and the Government Sukūk Act 2008 have the same legal status and position as other laws, such as the Law on Taxation and the Conventional Banking Act in Indonesia. These laws are placed one tier below the National Constitution (Undang-Undang Dasar 1945). Bank Indonesia issues regulations on Islamic banking under the Islamic and Conventional Banking Act, while guidelines on government Sukūk are issued through the Minister of Finance Decrees, as the Minister in charge of implementation of the Government Sukūk Act.

**Figure 7: The National Legal Structure**

![The National Legal Structure Diagram](image)

In Indonesia, the Majlis Ulema Indonesia (MUI) is the highest body for the issuance of Fatwa for the Muslim community. The MUI is not a state body, but a non-governmental organisation. The issue of Fatwa is centralised within MUI, which is supported by the Dewan Syariah Nasional (DSN) or National Shari’ah Council, and the Halal Food and Drug Supervision. The former issues Fatwa for Islamic finance, and the latter issues Fatwa in the area of foods and drugs. The Fatwa by DSN governs issues of Shari’ah applicability for all Islamic banking institutions, other financial institutions under the capital market supervision, and non-bank Islamic financial institutions.

However, the Fatwa of the DSN is not binding under Indonesian legislation unless it is included in the written laws, which are recognised as formal legislation. In this regard, in order to have binding powers, the Shari’ah principles or the Fatwa issued by the DSN shall be embodied in the written regulations issued by regulators – that is, Bank Indonesia. In this case, Bank Indonesia has established a Shari’ah Banking Committee to adopt Shari’ah principles based on the Fatwa, which are included in regulations issued by Bank Indonesia. In this way, Fatwa by the DSN are binding on Islamic banks in Indonesia.

There are several practical steps involved in the DSN issuing Fatwa. From product development perspectives, Fatwa initially will be issued if there is a request from the market players to Bank Indonesia as the regulatory authority. Bank Indonesia
will conduct an initial study to analyse the proposal, the results of which will be sent to the DSN, which will examine the permissibility from the Shari’ah perspective. After the DSN issues the Fatwa, Bank Indonesia will issue regulations for the products, but with a greater focus on the prudential perspectives. For prudential regulations, Bank Indonesia only uses the Fatwa as the reference point for issuing the regulation. A similar practice is also followed by other regulators such as the Indonesian Securities and Exchange Commission, which will refer to the Fatwa before issuing its regulations.

**Figure 8: The Position of Fatwa**

![Diagram showing the position of Fatwa]

- Fatwa issuance falls under the jurisdiction of MUI. The issuance is centralised to minimise confusion.

**Figure 9: The Process of Fatwa**

![Diagram showing the process of Fatwa]

- The Fatwa issued serves as reference points.
- To accommodate the Shari’ah compliance issues, Bank Indonesia issues regulation containing prudential principles and Shari’ah principles which are inspired by the Fatwa. This is to empower the authorities with higher level of credibility.
VI. Insolvency Framework for Islamic Banks in Indonesia

While putting in place the infrastructure to prevent insolvency is very important, developing an underlying regulatory framework that covers the specificities of Islamic finance to manage insolvency is also crucial. The fundamental problems faced in developing a process to manage insolvency, or putting in place an insolvency framework for Islamic banks in Indonesia, arise because the Shari’ah is not recognised by the law of the land when insolvency cases are brought before the courts. However, within this constraint, the Islamic banking industry in Indonesia has incorporated Shari’ah principles into the existing legal and regulatory frameworks. This was made possible by the close coordination between Bank Indonesia as the central bank and the regulatory authority for Islamic finance, with Majelis Ulama Indonesia (MUI) or the Indonesian Council of Ulama’ as the highest authority or Islamic body.

However, there is no Fatwa from MUI or Bank Indonesia regulation that is specific to the insolvency of Islamic financial institutions. According to Islamic law, any dispute arising in a Shari’ah transaction shall be settled either through consultation, arbitration or the courts. In Indonesia, a person having a Shari’ah case might bring the case to arbitration or to the religious court. Unless the parties agree to use the arbitration forum, any dispute in a Shari’ah transaction shall fall under the jurisdiction of the religious court.

Hence, Indonesian authorities have adopted three approaches to ensure bank soundness and to handle resolution and insolvency cases: (1) ensuring deposit insurance coverage for Islamic banks; (2) putting in place a Crisis Management Protocol to ensure stability; and (3) incorporating insolvency regimes at the product and institution level.

A. The Optimal Stopping Time — Requiring Islamic Banks to be Covered by Deposit Insurance

With Islamic banking assets accounting for a higher share of total assets of the banking system, the regulatory authority is in a pivotal position to ensure that a sustainable savings/investment process is implemented in order to maintain the stability of the Islamic banking system. The implementation of a deposit insurance arrangement seems to be unavoidable, although it may create moral hazard problems. Indeed, some deposit insurance arrangements have been implemented within the Islamic banking system in order to enhance the banks’ repayment capabilities to non-investment committed depositors (current and savings accounts).

The deposit insurance scheme was the outcome of lessons learned during the Asian Financial Crisis. The lesson is that, from the liability side, investors of Islamic banks should share the profit and loss. When Indonesia faced monetary turbulence, the interest rate spiked up to more than 50%, while at the time, Islamic banks could give investors only an 8% rate of return. At that point, most of the investors of Islamic banks remained loyal and could still accept lower rates without withdrawing deposits. However, once the potential risk for bank liquidation emerged, these depositors or investors started to withdraw their money. The lesson, then, is that at some point, investors/depositors in Islamic banks can share the profit but not the loss. It therefore became necessary for all Islamic banks in Indonesia to be covered under the deposit insurance scheme.
B. Crisis Management Protocol (CMP)

Financial policies should be set based on two possible conditions: normal business environment and during a crisis period. The financial crisis may be caused by natural disasters such as a tsunami, earthquake or disease outbreak, which are likely to result in major operational failures; or by other idiosyncratic failures that can adversely affect the financial system. The CMP covers the steps to identify potential threats to the financial stability which are sourced from problems in the banking industry, currency vulnerability, the interest rate, and other possible indicators leading to the financial crisis. The CMP should be equipped with various thresholds to define a financial crisis situation, since each country would have its own structure and characteristics that determine the level of financial resilience when facing a significant turmoil. After identifying the indicators of an emerging crisis, the CMP needs to have a well-understood and well-coordinated plan or procedures for returning the situation to normal.

In general, the establishment of CMP has two objectives. First, the CMP serves as the anticipatory action plan to maintain the operational soundness of the financial system even if it operates under significant financial pressures, so that the intermediary function can always be performed. Second, the CMP should promote possible prompt corrective actions to stabilise the system whenever necessary. In a period of crisis, the financial authorities sometimes need to make decisions which exceed their jurisdictions, and the actions need to be taken in a timely manner. The failure to act in a timely manner can make those actions ineffective. In order to make the CMP effective, there are a few steps that are considered worth taking, as follows:

1) Business Continuity Plan (BCP)

The financial authorities require the Islamic financial institutions to have a business continuity plan to anticipate significant financial disturbance. The BCP should also be supported by qualified human resources and adequate information technology that allows the management to take the right actions whenever necessary.

2) Framework for Coordination

It is essential that a solid legal foundation exists for the coordination of activities among the parties involved in the CMP decision-making process. This includes procedures for decision making, roles and responsibilities, flows of information, and sets of possible prompt corrective actions to be taken during the crisis.

3) Early Warning System

An information system that is capable of indicating financial turmoil is essential in the implementation of CMP. Accurate information about the market allows the authority to define the critical period based on the thresholds set by the financial stability committee, and to decide the actions to be taken.

4) Stress Test

The financial authority may conduct stress tests, as well as requiring the financial institutions to conduct such tests. Proper stress tests can improve mutual understanding among the market participants and the regulator. It also allows them to regularly identify weak areas that need to be improved.
C. Procedures for Managing Insolvency

Often, any discussion of the solvency regime for Islamic banks requires that we start at the product level, because it is only at the product level that the potential loss can be calculated. From the risk management point of view, bank officers must be able to arrive at a certain number that reflects the net worth of the product itself. Thus, the Shari‘ah contract should describe the financial products that are compliant with the relevant Fatwa that have been issued, in accordance with the classification of the product under the Shari‘ah principles.

The reporting and valuation of these Shari‘ah contracts will be aligned with the Islamic accounting standards. Based on these accounting standard, bank officers will try to interpret the valuation of Shari‘ah-based contracts, and how the liabilities should be paid by the contracting parties under the contract. Indonesia has adapted the international accounting standards as well as the AAOIFI standards to arrive at its own national accounting standards that are a blend of the conventional as well as Islamic accounting standards. By adopting this accounting framework, authorities have built an efficient financial system that gives more certainty to the players in calculating the potential risks in their transactions. Calculations based on these standards enable classification of claims by type. Following this, the risk management group tries to calculate the expected residual values in the balance sheet from the asset perspective as well as the liability side.

Figure 10: The Solvency Regime at the Product Level

The regulators also face a dilemma in dealing with ailing banks. In order to ensure that the banks conduct their fiduciary roles properly, the Islamic banking authorities should be able to design an optimal “closure” rule, either to close down ailing banks early (as has been adopted by the US banking authority under a prompt corrective approach (PCA)) or to subsidise them in order to give them the chance of self-recovery.

From the programme level, the authority will then conclude with a systematic and systemic picture of how the system can afford to support the financial impact of the insolvency of the bank. Having the framework in place enables Bank Indonesia to calculate the expected loss based on the exposure on the asset side, as well as on the liability side, to produce an accurate estimate of the net worth level. Bank Indonesia will also consider how the government can accommodate the potential loss. This will determine the exit policy that should be set out by the authorities. Overall, the banking authority cannot guarantee that no bank will fail; however, it will set up a safe
mechanism that allows the insolvent bank to exit without creating a substantial disturbance to the banking system.

**Figure 11: The Solvency Regime at the Institution and Macro Level**

VII. Experiences in Managing Disputes and Insolvencies

According to Islamic law, any dispute arising from a Shari’ah-based transaction shall be settled either through consultation, arbitration or the court. In Indonesia, a person having a Shari’ah case might bring it to arbitration or to the religious court. Unless the parties agree to use the arbitration forum, any dispute in a Shari’ah transaction shall fall under the jurisdiction of the religious court.

The religious court, in handling Shari’ah-based economic activities, will hold proceedings relating to a Shari’ah case, or it could decide that the case should be taken to a special court. Some experts are of the view that disputes relating to Shari’ah economic activities should be settled before the special court under the jurisdiction of the religious court, while others consider that the religious Act clearly stipulates the jurisdiction of the religious court in resolving Shari’ah cases.

However, it is difficult to explore and explain the lessons learned from insolvency cases of Shari’ah-compliant transactions in Indonesia because only 17 cases have been brought to arbitration in the past 13 years. Those cases generally related to transactions of Muḍārabah and Murābahah in the form of trust financing, purchasing goods and investments, as well as Takāful or Islamic insurance claims. There have been no cases of insolvency of Islamic banks.
VIII. Conclusions

The growth of the Islamic banking industry in Indonesia offers a number of benefits in sustaining the country’s economic growth by equipping the banking system with an additional pillar apart from the existing conventional one. However, in order to maintain its function optimally, the system should have the requisite supporting infrastructure and standards. These include: (1) well-defined and clear Islamic accounting standards that are able to translate Sharī’ah principles into financial transactions; (2) a capital adequacy standard that is able to link microprudential issues to macroprudential ones, so that it is capable of reducing potential moral hazard; and (3) a crisis management protocol that is capable of minimising the potential systemic problem, particularly when business conditions are abnormal. However, in order to be equipped to deal with insolvency problems that may arise due to the specificities of Islamic finance, the existing regulations would need to be enhanced. This could be achieved by developing infrastructures that recognise and incorporate Sharī’ah principles in the existing regulatory framework.
COMMENTARY THREE

INSOLVENCY REGIMES: REGULATORY, INSTITUTIONAL AND LEGAL CHALLENGES IN ISLAMIC FINANCE IN SAUDI ARABIA

Dr Mohammed Al-Sheaibi

I. Introduction

Insolvency laws are generally enacted to meet a country’s specific needs to undertake the resolution of problem transactions or institutions. They are usually described as being either “creditor-friendly” or “debtor-friendly”. While many countries have general insolvency laws, few of them have specialised insolvency laws for banks as part of their general insolvency laws.

Having insolvency laws for banking institutions have become more important recently, following the global financial crisis. Saudi Arabia, like many other countries, has general insolvency laws, and also a preventive bankruptcy settlement law.

II. Legal and Regulatory Framework for Insolvency Law in Saudi Arabia

The Company Law of the Kingdom of Saudi Arabia (KSA) issued under Royal Decree No. M/6 of 20 July 1965 consists of a separate chapter (Part XI of the Law) entitled “Liquidation of Companies”, which follows the chapter entitled “Conversion and Merger of Companies”. Article 218 of Part XI provides for the appointment of liquidators, and Articles 220 to 223 set out in detail the powers, functions and responsibilities of liquidators and the procedures to be followed during the process of liquidation. As all Saudi banks are joint stock companies, these laws apply equally to them. Similarly, the Regulations of Commercial Courts have a fairly comprehensive set of bankruptcy provisions, but they pertain mainly to traders and firms. The Preventive Bankruptcy Settlement Regulation of 1996 appropriately fills a gap in the existing scheme of commercial legislation. While providing relief to debtors, it also protects fairly the interests of creditors and entrusts to a judicial authority, the Council of Grievances, the supervisory powers pertaining to bankruptcy preventive settlement.

The Regulation encourages debtors to seek collective settlements with creditors through the intermediation of a special organ in the Chamber of Commerce, the Bankruptcy-Avoidance Ombudsman Council of Grievances (Diwān al-Madhāлим). On paper, the process resembles a European-style “accord” process, where the debtor remains in possession, and dissenting creditors can have a majority-approved plan. The KSA’s Ministry of Trade and Industry put in place the regulatory framework only in

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3 Published in the Official Gazette (Um AlQura) No. 3688, 26 January 1996.
2004, with Royal Decree No. 12 of 14/7/1425H, and the first conciliation commission was nominated only in May 2007.

III. Banking Law

Banking supervision in Saudi Arabia is a function of the central banking authority, the Saudi Arabian Monetary Agency (SAMA). The SAMA charter (passed by Royal Decree No. 23 of 15 December 1957) specifies in its first article that the regulation of commercial banks is one of its three main objectives. A separate supervisory law entitled the Banking Control Law 1966⁴ lays down in detail the powers and functions of the supervisory authority:

- Article 1 of this Law defines terms such as "bank" and "banking business";
- Articles 2 and 3 lay down the licensing requirement, procedure and criteria;
- The deposit liabilities of a bank, according to Article 6, are not to exceed 15 times its paid-up capital and reserves;
- Article 7 prescribes the maintenance of statutory deposit with the central bank and the maintenance of liquid reserve, the central bank retaining discretion to change both of the requirements within given limits;
- Article 8 prescribes the lending limit in respect of borrowing at 25 percent of the bank's paid-up capital and reserves which SAMA may increase to 50 percent in the public interest;
- Article 9 prohibits banks from lending against their own shares and from extending unsecured credit to directors, auditors and their own concerns;
- Article 15 prescribes monthly and annual reporting requirements of banks' financial positions;
- Article 16 provides for regulation of loan policies and procedures and related prudential requirements;
- Article 18 contains provision for on-site examination of banks by SAMA or by outside auditors assigned by it;
- Article 22 empowers the supervisory authority to take suitable corrective measures in the event of a bank's failure to comply with the Law, the related regulations and directives. These measures may include appointment of advisers, suspension and removal of any director or officer, limitation or suspension of credit extension or deposit acceptance and requiring the taking of other such steps as may be considered necessary; and
- Article 23 prescribes penalties on the contravention of the various provisions of the Law.

The question of insolvency in modern Islamic finance structures in legislation and bank solvency has not yet arisen in Saudi Arabia. There has been no urgency to prescribe specific legislation or procedures as over the last four decades, as there have been no cases of bank insolvency in Saudi Arabia. Currently, international banks have a presence in Saudi Arabia; and the question of international bank insolvency has not arisen either. "Nevertheless, the issue of making suitable provisions in the law for insolvency for Islamic finance structures and bank insolvency and liquidation should be under consideration as part of the broader task of revising the laws in banking and insolvency for Saudi Arabia.

IV. Insolvency Regimes for Islamic Finance

Insolvency issues in Islamic finance are governed by provisions in the general insolvency Law of Saudi Arabia. Judges will look at both the form and the substance of contracts, and, according to the Islamic jurisprudence rule, substance will override the form and title.

Internationally, the question of insolvency in modern Islamic finance structures has only recently come up. The issue of making suitable provisions in the law for insolvency in Islamic finance lacks urgency as financial difficulties are mostly resolved out of court, with only a very tiny percentage settled by the courts. As such, there is limited documentation of experiences in the resolution of insolvency cases. This has proven to be a constraint in building a reference of case examples and providing the background against which parties can refer to in negotiating structures, bank insolvency and liquidation. It is therefore beneficial to consider putting in place legislations or processes for an insolvency regime, as part of the broader task of revising banking and insolvency laws.

However, the contract between a bank and its customers plays an important role in identifying the responsibility of each party. In the case of the customer depositing money without any intention of making a profit, that deposit should be guaranteed by the bank, to be paid back to the customer. On the other hand, if the customer deposits money in the bank with the intention of making profit, the contract should clarify the role of the bank vis-à-vis the money deposited, as well as the role of the bank as a partner in the investment. It would be equivalent to the bank having some of its monies in the investment. In this case, the customer and bank share the profit and the loss. In the case where the bank acts as an agent, performing the instructions of the customer, whereby the customer makes the decisions, the profit and the loss will be borne by the customer and not the bank. The above describes the relationship between the parties under the assumption there is no negligence on the part of the bank.

The preventive Bankruptcy Law offers two ways to reach a settlement to prevent bankruptcy:

1. Through the Chamber of Commerce and Industry, where the company in distress submits a request to committees established under the Chamber to solve the issue in an amicable manner.

2. Through the Council of Grievances, where the company in distress submits to the Council a request for a judge to call on the company’s creditors to offer them a settlement to prevent bankruptcy. The request includes details of the company’s assets, amounts of debits and credits, and lists of its creditors and debtors, as well as the reason why the company is in distress and the conditions of the settlement proposal.

The insolvency issue in an Islamic Bank (Sharī‘ah-compliant bank) and financial institution would be subject to a model law which does not conflict with Sharī‘ah and allow for balancing the interests of the creditors and debtors. Such a model law can be adopted as a guide to countries considering drafting new insolvency laws. This model law approach can also lead the way to eventually harmonise the laws dealing with this issue among interested countries. However, discussion, research and drafting of a model law require hard work and will take time. International
organisations such as IFSB or the IDB should consider organising conferences on these issues and invite experts from the business side who are practitioners in Islamic finance dealing in structuring Islamic finance products to share their views and experiences on managing insolvency cases, at the point of transaction as well as insolvency cases of the institutions offering Islamic financial products.

In addition, the organisers should also invite regulators and insolvency practitioners and Shari’ah experts to give their opinion about this issue. This may be more effective than just appointing a consultant and working group to produce a model law for Islamic law bank Insolvency. The work on the model law should take into consideration previous cases and judgments and findings by Islamic jurisprudence experts.

It is important to have such a model law, especially for countries aiming to become a global Islamic financial centre. Such a model law or a guide for drafting such a law can also be useful in the drafting of contracts in Islamic financial product transactions or in living wills for Islamic banks to use in cases of insolvency.

It is important to study the cases where the courts have issued judgments that differ from what is expected from the documentation of Islamic finance products, and the reasoning of the court judgment. Scholars and lawyers have to study these judgements carefully and use any consequent solutions judiciously in proposing or making changes to the documentation of Islamic finance products to reflect the decisions reached by courts’ judgment and reasoning. This is because this documentation will impact future cases that may arise in disputes or insolvency cases, which may have to be dealt by the courts. The revision to the documentation should therefore aim to ensure that settlement by the courts will be within the expectations.
CHAPTER FOUR

INSOLVENCY REGIMES: DEVELOPING AN ANALYTICAL FRAMEWORK FOR MEETING LEGAL AND REGULATORY CHALLENGES FOR ISLAMIC FINANCE

By Sau Ngan Wong and James Seward
CHAPTER FOUR

INSOLVENCY REGIMES: DEVELOPING AN ANALYTICAL FRAMEWORK FOR MEETING LEGAL AND REGULATORY CHALLENGES FOR ISLAMIC FINANCE

Sau Ngan Wong1
James Seward2

I. Introduction

In a global environment that has become increasingly challenging, Islamic finance has experienced rapid expansion and is fast emerging as a viable and competitive form of financial intermediation with significant potential.

The Islamic financial services industry has been growing at a rapid pace— and the industry is poised to expand at a faster rate going forward particularly in the aftermath of the current crisis. Countries with a growing Islamic financial services sector – Bahrain, Brunei, Indonesia, Islamic Republic of Iran, Malaysia, Pakistan, Sudan and the UAE, among others – have targeted an expanding share of Islamic-based assets in their financial systems, cutting across all types of financial services including banking products, *takaful* (insurance), and developing both the money and capital markets. Some estimates put market growth at approximately 15% per annum over the last three years. Islamic finance is not restricted to Muslim countries only and is now in practice in many non-Muslim countries.3 Box 1 below provides a few detailed examples from East Asia of this rapid growth of Islamic finance.

<table>
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<th>Box 1: Islamic Finance in East Asia</th>
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<td>The countries in the East Asia and Pacific (EAP) region represent a quarter of the global Muslim population. The region has made tremendous progress in the development of Islamic finance in terms of policies, regulation and markets. Malaysia is taking a leading role in Asia, with Islamic banking making up about 14% of the country’s banking system. This figure is targeted to reach 20% by 2010. Within Asia, Malaysia is very active in developing Islamic capital markets and accounts for 95% of all Islamic bond issuances. Although Islamic financial assets represent only less than 2% of total financial sector assets in Indonesia, the growth of <em>Shari’ah</em> banking in Indonesia has been rapid with an almost tripling of the number of offices from 2006 to 2007 (up from 456 to 1195 offices) and 33% growth in assets.</td>
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One of the most important growth segments is the *Sukūk* market. Global *Sukūk* issuance grew by 40% in the first ten months of 2009, while the total amount of *Shari’ah*-compliant *Sukūk* outstanding is estimated to surpass $100 billion, more than doubling in ten years. However, these overall statistics and market dynamics may actually underestimate the importance of Islamic finance because some market studies

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2 Mr James Seward is a Senior Financial Sector Specialist for East Asia and Pacific Region at the World Bank.
3 According to some statistics, the size of Islamic finance market in UK is larger than the size of Islamic assets in Pakistan.
suggest that Islamic banks could account for up to 40–50% of total deposits in countries with Muslim populations within the next decade.

Figure 1: Size of the Sukūk Market

As the Islamic financial services industry expands to new countries and its share of total financial sector assets continues to increase, it will inevitably impact the way global finance evolves to support real sector economic activity, as well as financial services being a driver of economic growth.

The integration of Islamic finance with international financial markets and institutions today, along with the wide geographical expansion of market activities outside the traditional jurisdictions of the Middle East and Asia, demonstrates that Islamic finance has the potential to develop as an inclusive and stable financial system. The global financial crisis generated much interest in Islamic finance as a form of financial intermediation that can promote financial stability due in part to the Sharī‘ah requirement of a direct linkage between financial activities and the real sector, the prohibition of speculation and interest-based structures, and the requirement for high ethical standards in business conduct.

On the other hand, the integration of financial markets has not insulated the Islamic financial services industry in that several Islamic financial services providers and instruments were threatened with failure, and indeed some Sukūk have defaulted, largely from the second-round effects of the global financial crisis. Indeed, the recent financial crisis has given renewed urgency to the need for effective resolution systems for financial institutions which safeguard financial stability and minimise moral hazard. Wide participation in the Islamic financial markets by both conventional and Islamic financial institutions had raised awareness among regulators and market participants that in the event of default by a borrower (which traditionally kicks off legal proceedings), there is insufficient clarity and certainty of the claims of creditors against the borrower, or in respect of an Islamic financial transaction, between the participants to the transaction.

In order to continue to build confidence in the Islamic financial services sector that has wide participation globally, awareness and proper understanding of the issues
and challenges affecting financial institutions that offer financial services (hereinafter referred to as “IIFS”\(^4\)) in the event of insolvency is important as a first step towards developing effective resolution framework for such IIFSs. In addition, the uncertainty on the claims on the underlying assets of Islamic financial products and differences in interpretation across jurisdictions on Shari’ah can potentially complicate resolution procedures and jeopardise market participants’ confidence in Islamic finance. Stakeholders in the Islamic finance industry will focus closely on the outcomes of these disputes so as to ensure that their investments/products remain sufficiently robust during this period of economic uncertainty.

**Box 2: Issues that Arise in the Event of Default in Sukūk**

In the Shari’ah-compliant Sukūk issued by Nakheel (a subsidiary of Dubai World) and whose primary source of repayment to Sukūk holders is the rental payments under the lease and the purchase obligations with respect to the lease rights of government-owned entities, concerns arose as to whether the holders of Sukūk are able to have recourse to the underlying assets. This is because there are provisions under Dubai law that no debt owned by the ruler or government can be recovered by taking possession of the government’s assets, and that proceedings may only be brought against government entities. There is also scant guidance on the role of the court in Dubai, as the prospectus for the Nakheel Sukūk states that judicial precedents have no binding effect on subsequent court decisions that are generally not recorded. Even though the Dubai government established a Tribunal on 13 December 2009 to decide on disputes relating to the settlement of the financial position of Dubai World through Decree No. 57, the adoption (with modifications) of the insolvency law of the Dubai International Financial Centre as part of its domestic legal framework (which incorporates features of common law) makes it uncertain as to whether the Tribunal would give effect to Shari’ah principles that may be applicable to the Sukūk if they are not compatible with common law.

This paper proposes to examine some of the challenges and issues in relation to the legal, institutional and regulatory challenges for the effective resolution of IIFSs in the event of insolvency. The discussion in this paper is part of a broader work agenda of the Islamic Financial Services Board and the World Bank pursuant to the Memorandum of Understanding that was signed in November 2009 to explore and study problems and issues relating to effective resolution regimes for Islamic finance. By undertaking the analysis and diagnostics in a comprehensive way, and on all aspects of insolvency affecting IIFSs including Islamic banks, the collaboration between the IFSB and the World Bank, among other things, is aimed at providing policy-makers and regulators a sound analytical framework for addressing issues and challenges and evaluating approaches that are consistent with the Shari’ah\(^5\) and benchmarked against international best practices. However, the findings, interpretations and conclusions expressed in this paper are entirely those of the authors. They do not necessarily represent the views of the International Bank for Reconstruction and Development/World Bank and its affiliated organisations, or those of the Executive Directors of the World Bank or the governments they represent.

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\(^4\) Unless specified otherwise, an IIFS would include an Islamic bank.

\(^5\) Shari’ah refers to the sacred law of Islam. All Muslims believe that Shari’ah is God’s law, but they differ as to exactly what it entails. In original usage, Shar’iah meant the road to the watering place or path leading to the water – that is, the way to the source of life. The technical application of the term as a reference to the law of Islam is traced directly to the Qur’an, wherein the adherents of Islam are admonished by Allah (God) to follow the clear and right way, the path of Shari’ah.
II. Existing International Principles and Guidance on Insolvency and Creditor Rights

The World Bank’s Principles for Effective Insolvency and Creditor Rights System ("ICR Principles") were developed in 2001 (and subsequently revised in 2005) in response to requests from the international community in the aftermath of the Asian financial crisis to identify internationally recognised best practices in the design of insolvency laws and the due protection of creditor rights. These Principles were developed to deal with failures of commercial entities, as they do not address bank insolvencies specifically. This is because it is widely accepted that the legal, institutional and regulatory framework for bank resolution needs to be differentiated from the Principles in order to ensure that bank regulators are able to take swift and effective actions to instil confidence and contain systemic risks. Hence, a gap exists in that the Principles were not designed specifically for banking institutions, and certainly not for Islamic banks.

While there is much uniformity of banking law and regulations governing the legal status, organisation and prudential regulation of banks, there is much less agreement on approaches to bank insolvencies. Unlike insolvency laws that apply to commercial entities that can take effect after insolvency has been declared under appropriate legal procedures, bank regulators often have the authority to commence corrective actions against a bank that is about to become insolvent or is declared by the bank regulators to be insolvent.6 Bank restructuring or rehabilitation constitutes part of a continuum ranging from regulatory enforcement of prudential regulations to receivership.7 The legal framework for bank restructuring typically addresses issues in relation to bank restructuring techniques;8 negotiations with prospective investors; transfer of assets and liabilities from the bank to interested parties; and the requirement for supervisory approval of restructuring arrangements.9 An equally important consideration for bank insolvency is the need for prompt and timely action that is taken on a sound legal basis to contain the effects of a potential systemic crisis. Therefore, the differences between rehabilitation for commercial entities and bank restructuring have important consequences for the rights of creditors and owners under the law.

With the global financial crisis unravelling in 2008, the International Monetary Fund (IMF) and the World Bank jointly published a paper on 17 April 2009 entitled “An Overview of the Legal, Institutional and Regulatory Framework for Bank Insolvency” ("Overview of Bank Insolvency") for conventional banks and financial instruments. The paper provides an overview of the legal, institutional and regulatory framework that countries should put in place to address cases of bank insolvency. While conventional insolvency regime would be applicable to IIFSs to the extent applicable, there are nonetheless gaps given the unique characteristics of Islamic finance and the re-characterisation of the legal relationships between IIFS and their customers based on the structure of the contracts (so as to be Şarî'ah compliant) which underpins the Islamic financial transaction. As a consequence, these gaps give rise to a lack of clarity and uncertainty for parties who deal with such IIFSs in the event of insolvency of such

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6 In terms of the choice of bank insolvency regime, some countries apply their corporate insolvency framework, with appropriate modifications for banks, while other countries put in place a special legal regime for cases of bank insolvency. In recent years, there has been a trend towards the establishment of a special regime. While corporate insolvency proceedings invariably take place in the courts, insolvency proceedings under a special regime for banks may be either court-based or administrative in nature.

7 Various methods can be used for the purpose of restructuring a bank in the context of insolvency proceedings. These techniques may be carried out in official administration and, in some cases, in liquidation proceedings.

8 Whereby a wide variety of restructuring techniques are used either separately or in combination.

9 Banking supervisory authorities must be able to approve new major shareholders and senior managers on fit and proper grounds, and examine the terms of restructuring transactions to ensure that prudential standards will be met.
institutions. Therefore, in order to build a financial sector that is stable and sustainable and which minimises moral hazard, there is an urgent need to further extend the work carried out to enhance our understanding of the relevant issues and challenges involved in the effective resolution of IIFSs.

It would be useful here to make reference to the important elements of the legal framework for resolution of conventional banks, and to analyse the specific issues that may present uncertainty and ambiguity in the resolution of IIFSs. Official administration of a bank usually involves two phases: (i) diagnosis; and (ii) restructuring and liquidation.  

**Box 3: Official Administration and Restructuring of Conventional Banks**

The important elements of the legal framework for the official administration of banks would incorporate the following:

- appointment, replacement and discharge of an official administrator;
- threshold requirement that permits the commencement of official administration;
- transfer of control from owners/managers to official administrators, including the scope of control so transferred;
- protection of assets, and continuing operations and business of the bank;
- declaration of moratorium on a discretionary basis;
- licensing implications of the insolvent bank; and
- termination of official administration following necessary restructuring and when the bank is restored to financial health.

Important elements of the legal framework for the restructuring of conventional banks would include the following:

- The official administrator would negotiate conditions of sale subject to supervisory approval with prospective investors and determine valuation of assets at market value;
- Transfer of assets and assignment of liabilities from the bank to interested investors, either on a piecemeal or as a pool;
- Approval of bank supervisory authorities of restructuring plan and approval by them of fit and properness of new major shareholders and managers;
- Use of proprietary information by the official administrator for disclosure purposes to prospective investors subject to confidentiality requirements.

In as far as liquidation of banks is concerned, the purpose of the liquidation proceedings is to maximise the realisation of assets and their orderly and equitable distribution to creditors, resulting in the insolvent bank being dissolved as a separate legal entity.

**Box 4: Legal Framework for the Liquidation of Conventional Banks**

- Authority is provided for the appointment of a liquidator who would take full control of the bank’s assets.
- The liquidator has the power to preserve the bank’s assets and protect their value.
- There is a high degree of transparency and accountability in the liquidation process.
- An automatic moratorium on, or suspension of, all collection activity against the bank may be imposed.
- Provision is made for the treatment of uncompleted transactions in the payment and securities settlement systems, and of netting, set-off, novation/close-out arrangements in financial contracts.

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The liquidator is empowered to terminate executory contracts in which the parties have not fully performed their obligations. The liquidator is authorised to manage the assets of the insolvent bank, and to restructure loans and transfer contractual relationships, without the consent of the counterparties. Filing of claims by creditors with the liquidator and, to the extent that there is a deposit insurance protection scheme, the ability of the deposit insurance agency to subrogate to the rights of depositors against the bank when payments have been made to depositors. Liquidation proceedings are terminated upon completion of the final distribution and dissolution of the bank as a separate legal entity.

In our analysis of the applicability of the conventional resolution framework for IIFSs, we would argue that, rather than developing an approach that “re-invents” a new resolution framework, there is merit in adopting an approach that reviews only specific aspects of the resolution framework for IIFSs by taking into account the unique characteristics of Islamic finance and the relationships between these institutions and their customers. In this regard, the potential areas that may give rise to uncertainty in the event of insolvency of an IIFSs are in respect of: (i) for the official administration framework, in the area of protection of assets by the official administrator upon assuming control of these institutions and the transfer of such assets to prospective investors;\footnote{See Box 3.} and (ii) for the liquidation framework, in the areas of treatment of uncompleted transactions in the payments and uncompleted securities settlement system and the treatment of netting, set-offs/close-out of financial transactions, the termination of executor contracts which parties have not fully performed and the ranking of creditors.\footnote{See Box 4.} The following discussion focuses on the distinguishing features of Islamic financial contracts that IIFS enter into with their customers.

III. Unique Characteristics of Islamic Banks and Islamic Financial Transactions\footnote{The discussion on the balance sheet in the following paragraphs is only in respect of Islamic banks, rather than an IIFS, in view of the fact that the balance sheet of an IIFS would be quite different from that of an Islamic bank since Islamic financial transactions that IIFS engage in may be within a conventional framework.}

Islamic banking entails the provision of a range of services, including banking services and products, services and products with similar characteristics as in securities services and products, and real estate investments. A significant part of Islamic banking business is fee-based and profit-sharing activities, not only in retail banking business but also in corporate and capital market activities. Assets of an IIFS range from products that are similar to conventional banking products, to risk-sharing assets that are unknown in conventional banking. Hence, Islamic banks are typically a hybrid between a conventional commercial bank and an investment bank that resembles a universal bank. Table 1 presents a simplified balance sheet of an IIFS that illustrates the general structure of intermediation using a variety of Islamic contracts.
CHAPTER FOUR: INSOLVENCY REGIMES: DEVELOPING AN ANALYTICAL FRAMEWORK FOR MEETING LEGAL AND REGULATORY CHALLENGES FOR ISLAMIC FINANCE:

Table 1: Balance Sheet of IIFS

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>LIABILITIES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and cash equivalent</td>
<td>Non-remunerated current account (Qard al Hassan)14</td>
</tr>
<tr>
<td>Short-term interbank Murābahah15</td>
<td>Short-term Murābahah, interbank and due to customers</td>
</tr>
<tr>
<td>Investment Sukūk</td>
<td>Long-term syndicated Murābahah</td>
</tr>
<tr>
<td>Other investments</td>
<td>Issued Sukūk</td>
</tr>
<tr>
<td>Credit portfolios</td>
<td>Unrestricted Profit-Sharing Investment Accounts (PSIAs)</td>
</tr>
<tr>
<td>Participation (Mushārakah)16</td>
<td>Profit equalisation reserves and Investment Risk Reserves</td>
</tr>
<tr>
<td>Others</td>
<td>Equity/capital</td>
</tr>
</tbody>
</table>

Based on the simplified balance sheet of an Islamic bank, it is apparent that the legal relationship between the Islamic bank and its customers and depositors is quite different from the relationship between a conventional bank and its depositors. The structure of an Islamic bank utilising the different types of contracts gives rise to unique legal relationships between the Islamic bank and its customers based on Shari‘ah.17 Unlike conventional banks, which accept deposits with the assumption of capital preservation and a promised return, an Islamic bank does not offer such an explicit guarantee; however, it has to assure depositors that it will select the best opportunities to minimise the risks for such depositors.18 On the liabilities side of the balance sheet, an Islamic bank offers current, savings, investment and special investment accounts to the depositors – the current accounts are based on the principle of Wad‘iah (trust or safekeeping), creating an agency contract for the purpose of protecting and safeguarding the depositors’ assets. The major portion of the liabilities of the Islamic bank would consist of investment accounts that are, strictly speaking, not liabilities but a form of equity investment, generally based on the principles of Mu‘ārabah and Mushārakah.

The unique funding structure of an Islamic bank raises the issue as to how Profit Sharing Investment Accounts (“PSIAs”) should be dealt with from prudential as well as from insolvency perspectives. Since the PSIAs are treated as Shari‘ah substitutes for conventional retail deposits, there is always the concern of policymakers if the PSAI holders believe that they are likely to suffer a loss of their capital, they may withdraw their funds and start a run on the Islamic bank, with the risks of contagion throughout the financial system. PSIAs are often pooled investments which can be either restricted (where the investments are specified) or unrestricted (where the investments are unspecified). Often, they are structured as Mu‘ārabah agreements in that the investor bears the full risks unless there is negligence,

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14 Qard al-Hassan refers to a zero-interest loan, as Qard al-Hassan is seen as a forgone interest that banks could make otherwise.
15 Mushārakah (joint venture) is an agreement between two or more partners, whereby each partner provides funds to be used in a venture. The Murābahah involves a financier purchasing an asset, such as a commodity, for supply to a purchaser who does not have the capital to purchase the asset. The financier and purchaser agree on a profit margin, which is added to the cost of the asset. Profits made are shared between the partners according to the invested capital. In case of loss, each partner loses capital in the same ratio. If the bank provides capital, the same conditions apply. It is this financial risk, according to the Shari‘ah, that justifies the bank’s claim to part of the profit. Each partner may or may not participate in carrying out the business. A working partner gets a greater profit share compared to a sleeping (non-working) partner.
16 Mushārakah or joint venture participation is a partnership based on capital contribution where two or more people combine either capital or labour to share profit and losses. The difference between Mushārakah and Mu‘ārabah is that, in Mushārakah, each partner contributes some capital, whereas in Mu‘ārabah, one partner – that is, a financial institution – provides all the capital and the other partner, the entrepreneur, provides no capital.
17 Ibid.
18 Ibid.
misconduct or breach of contract on the part of the Muḍārib. To-date, there is as yet no consensus among regulators as to how unrestricted PSIAs should be regulated i.e. either as a deposit or as an investment.

There can also be PSIAs that do not fall within any of the abovementioned categories. The risks arising are that to the extent that the legal form of a PSIA is unclear, and to the extent that the investors’ funds are segregated, would the segregation be upheld in an insolvency of an Islamic bank? The issue as regards the claims of the PSIA holders relative to other depositors such as the holders of Wadī‘ah19 current accounts would need to be determined. For unrestricted PSIAs where the capital of PSIA holders is commingled with the equity of the Islamic bank, it would also be necessary to determine if the protection normally given to depositors in terms of ranking is accorded to the holders of unrestricted PSIAs in the event of insolvency of an IIFS and the applicability of deposit insurance for such PSIAs. According to AAOIFI20 standards, the Muḍārabah investor may receive a guarantee from a third party, in this case, the national deposit insurance. Another important issue that needs to be addressed is since the holder of a PSIA account bears the risks as an investor under the Muḍārabah contract, unless there is negligence or misconduct on the part of the Islamic bank’s management, there is the need for a transparent criteria and process to determine if the insolvency of an IIFS is in fact triggered by the misconduct or negligence of its management.

A. Sukūk

Sukūk potentially can appear as assets or liabilities on the balance sheet of an Islamic bank. For example, Sukūk that the Islamic bank holds as investments would appear on the assets side. Sukūk that appear as liabilities on an Islamic bank’s balance sheet represent the instruments that are issued by the Islamic bank to raise funds. A Sukūk is often structured in a way so as to generate the same economic effects as conventional bonds but in compliance with Shari‘ah. Since, in principle, most Sukūk have tangible assets as their underlying asset, one might assume that they are similar to asset-backed securities.

However, a detailed analysis of the legal structures and commercial terms would show that some Sukūk may not be governed by asset performance at all. Structured as a trust, rather than based on a debt relationship, the Sukūk revolves around a special-purpose vehicle (SPV) that is typically set up as a trustee (“Issuer/Trustee”) which buys an underlying asset from the obligor using funds from the investors (“the beneficiaries”), who during the life of the Sukūk share among themselves the income generated by such asset (for example, the rental paid by the obligor for the use of the asset). On maturity, the SPV sells the asset back to the obligor and the price is distributed to the investors who can so recover the initial capital invested in the transaction. If a default occurs, the investors can only try to recoup their investment by forcing the Issuer/Trustee to sell the asset to the obligor and suing the obligor if the price is not paid. Because of its structure, the role of the Issuer/Trustee of the Sukūk is instrumental to the enforcement of the investors’ interests. The

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19 Wadī‘ah or safekeeping is an instrument that allows a person to keep the wealth or assets belonging to oneself with another person for safekeeping purposes. Wadī‘ah in the legal sense signifies a thing that is entrusted to the care of another. The proprietor of the thing is known as Mudi’ (depositor), the person entrusted with it is known as Wadi’ or Mustawda’ (custodian) and the deposited asset is Wadī‘ah.

20 Accounting and Auditing Organization for Islamic Financial Institutions that was set up as an Islamic international autonomous non-for-profit corporate body that prepares accounting, auditing, governance, ethics and Shari‘ah standards for Islamic financial institutions and the industry. As an independent international organisation, AAOIFI is supported by institutional members (200 members from 45 countries, so far) including central banks, Islamic financial institutions, and other participants from the international Islamic banking and finance industry, worldwide. For more information, please see www.aaoifi.com
Issuer/Trustee is the only party that has rights to enforce payment, as the Issuer/Trustee is the creditor of the obligor. It is important to note that the party that needs to go into administration in the event of non-payment is the obligor for a Sukūk, which results in lack of control by holders of Sukūk.

Because the underlying assets and the transaction structure for Sukūk need to satisfy both commercial law and Shari‘ah, it is entirely possible that, in the event of insolvency of an issuer of Sukūk, inconsistencies may arise concerning asset control and bankruptcy resolution for investors in non-Islamic countries. For example, conventional insolvency procedures that are subject to Shari‘ah can potentially displace investor protection such as bankruptcy remoteness and repayment guarantees, in that the rights and agreements under conventional commercial law may encroach upon the inseparability of investor return and asset performance as required by Shari‘ah. There can also be issues regarding the enforceability of asset claims by holders of Sukūk, including unclear creditor rights. This is because, under Shari‘ah, issuers and investors are required to equitably share transaction-related profits or losses, yet the actual covenant of the Sukūk agreement may not give effect to that.

Determining the scope and nature of the rights and obligations of the parties in a Sukūk transaction is even more complex in jurisdictions in which the civil code governs company regulation and commercial entities. An example may be in the Sukūk that is structured on Mushārakah principles in the areas of asset contribution and security structures. In some civil law jurisdictions where common law trust does not exist, techniques to structure around restrictions on transfer of assets to a Mushārakah under the notion of an adl (quasi-fiduciary) can pose risks in that third parties may be able to assert against such assets in terms of priority with respect to payment of such claims. Therefore, one key issue with regard to Mushārakah structures would be the determination of the position of the underlying assets in the event of insolvency. A strategy that market participants often resort to is ring-fencing the underlying assets through the true sale arrangements in order to protect such assets from insolvency proceedings by affiliates of parties involved in such transactions.

The other important issue is in relation to bankruptcy remoteness in a Sukūk transaction. Generally, an SPV would be established to ensure insolvency remoteness by way of provisions in the Sukūk documentation that would restrict the purpose and activities of the SPV to the Sukūk transaction only. In ensuring bankruptcy remoteness of the SPV, several covenants would be imposed on the issuer. But such covenants may raise difficulties, such as for Sukūk that are structured according to Ijārah principles which require the assets, financial statements and fund of the funding company to be shared with those of the project company. This would render the bankruptcy remoteness covenants in the documentation to be non-compliant with Shari‘ah. As a consequence, there is the need to ensure that the originator, investors and credit enhancers agree not to initiate bankruptcy proceedings against the issuer. The issuer would also undertake not to initiate voluntary bankruptcy proceedings.

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21 For example, in U.A.E., a business venture is governed by civil code pursuant to the U.A.E. Federal law No. 5 of 1985.
23 Ibid.
24 Ibid.
25 Ijārah means lease, rent or wage. Generally, "Ijārah concept" means selling the benefit of use or service for a fixed price or wage. Under this concept, the Islamic bank makes available to the customer the use of service of assets/equipment such as plant, office automation, motor vehicle for a fixed period and price. Ijārah contracts are often used in Sukūk, whereby the seller and the user of the underlying asset are the same economic entity (lease-back); periodic rental payments serve as the source of periodic payments to Sukūk holders through an SPV.
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As for restructuring a Sukūk, it would appear that the same fundamental rules as in the restructuring of conventional bonds would not apply to Sukūk. The Issuer/Trustee of a Sukūk is not typically set up to issue a new instrument that can be used as part of the Sukūk restructuring. From a Şari‘ah perspective, amending the trust certificates may not be compliant with Islamic principles. In addressing this challenge, some market practitioners utilise a strategy whereby the obligor would create a parallel Sukūk using a new Issuer/Trustee with a new set of assets, and to swap new for old and release the old assets.

IV. Concepts Underlying Islamic Banking Assets that have Implications for Insolvency

The structuring of various financing contracts that are based on Şari‘ah have important ramifications for the types of legal relationships that the IIFS have with the parties who contract with them. These concepts are briefly discussed below.

A. Concepts of Ownership and Possession

Ownership and possession are two important elements in Islamic financial transactions, such as in the Ijārah and Istinā‘ structures. In regard to such Ijārah and Istinā‘ structures, concerns have been raised as to whether the funder’s retention of title will be “superior” that would override the interests of the insolvent entity. This may result in the retention of title clause to be re-characterised by the courts as a clause creating a security interest. Where title has clearly been retained by the seller and it is clear from the structure that there is no transfer of ownership, English courts will not re-characterise such retention of title clauses as creating security interests that would fail in the event of insolvency of the buyer/lessee for lack of registration. It would seem that different jurisdictions approach these concepts of ownership and possession differently, and the different approaches could potentially lead to much confusion in resolution of an insolvent IIFS. This is a fundamental issue, as there is no unifying set of standards in this area, which will make it difficult to build the industry in the long term on a global basis.

B. The Financier as Landlord

In conventional finance, a bank involved in mortgage financing would only need to take a legal charge over the property in order to ensure that there are adequate provisions built into the security documents in order to prevent them becoming the owner or having possession of the asset in the event of a default. However, in a Murābahah real estate transaction, there is the risk that the insolvent debtor may

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27 Ibid.
28 Ibid. Common law courts would not re-characterise the retention of title clause so as to be creating security interests. The other approach (commonly termed the “functional approach” and largely followed by the United States, New Zealand, Canada and civil law jurisdictions) treats a conditional buyer or a lessee as merely a possessory interest, and the seller or lessor enjoys absolute ownership by virtue of the agreement between the parties. Reservation of title clauses in such agreements between the seller and lessor, and the buyers and lessees, are treated much like chattel mortgages.
29 Ibid.
30 This concept refers to the sale of goods at a price, which includes a profit margin agreed to by both parties. The purchase and selling price, other costs, and the profit margin must be clearly stated at the time of the sale agreement. The bank is compensated for the time value of its money in the form of the profit margin. This is a fixed-income loan for the purchase of a real asset (such as real estate or a vehicle), with a fixed rate of profit determined by the profit margin. The bank is not compensated for the time value of money outside of the contracted term (that is, the bank cannot
disclaim the unexpired portion of the Murābahah lease, which would result in possession of the property reverting to the bank as landlord. There is a need for clarity on how this would impact these types of transactions in the event of insolvency of an Islamic financial services provider.

C. The Financier in Control

Another issue is in regard to the position of the financier in control of clients’ business. From the conventional point of view, the bank as a lender takes meticulous precautions to avoid any action that may lead to the bank taking control of the borrower company. However, in Islamic finance, there is the possibility that this approach may not be appropriate in Muḍārabah/Mushārakah transactions. Under such contractual arrangements, the IIFS is a partner and has the right to take over the management of the borrower company. Yet, such an approach by the IIFS may not be allowed by law in certain jurisdictions.

D. Separate Legal Personality under Shari‘ah and Corporate Veil

There is also uncertainty in regard to Shari‘ah compliance of the modern concept of a corporation, which assumes a separate legal personality from its owners. Some Shari‘ah scholars have expressed reservations as to whether the concept of a modern corporation and limited liability entity is recognised from a Shari‘ah point of view as a separate legal personality with rights and responsibilities imposed on the entity. This issue becomes important in the event of insolvency of a debtor. If the separate legal personality concept is not recognised under Shari‘ah, it could be used as a basis for avoiding legal liability or even for perpetrating a fraud.

V. Going Forward

Clearly, there is an urgent need to deepen our understanding of how the Shari‘ah affects an IIFS in the event of insolvency, and the implications for those interested in dealing with such an IIFS. In developing an analytical framework that would assist policy-makers, regulators and market participants to address these issues and challenges, it would be necessary for us to deal with the following:

- **Need for a deep understanding of the legal risks and unique characteristics of the relationships between IIFS and the parties who deal with such institutions:** There is a pressing need to understand the foregoing in order to provide certainty for all parties in regard to their legal rights in the event of the IIFS’s inability to pay, or to pay in full, whatever is due to them in consequence of their dealings and relationships. This, in turn, enables the

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32 Mushārakah (joint venture) is an agreement between two or more partners, whereby each partner provides funds to be used in a venture. Profits made are shared between the partners according to the invested capital. In case of loss, each partner loses capital in the same ratio. If the bank provides capital, the same conditions apply. It is this financial risk, according to the Shari‘ah, that justifies the bank’s claim to part of the profit. Each partner may or may not participate in carrying out the business. A working partner gets a greater profit share compared to a sleeping (non-working) partner. The difference between Mushārakah and Muḍārabah is that, in Mushārakah, each partner contributes some capital, whereas in Muḍārabah, one partner – for example, a financial institution – provides all the capital and the other partner, the entrepreneur, provides no capital.
parties that deal with such IIFIs to assess the economic implications of such default, and hence to estimate and manage risks appropriately.

- **Need for understanding of Sharī‘ah principles on insolvency:** To date, there is very little understanding of the Sharī‘ah with regard to insolvency and its application in the modern financial system. The Roundtable Discussion that was jointly organised by the IFSB and the World Bank on 10 October 2010 in Washington, DC was aimed to raise awareness, among other things, of the Sharī‘ah principles on insolvency and their implications for modern financial contracts. The inevitable conclusion of the Roundtable was the critical need to promote greater awareness and understanding of the Sharī‘ah in respect of insolvency.

- **Enforceability of Islamic financial products and their potential inherent incompatibility with Sharī‘ah principles, particularly in the event of insolvency:** An issue with Islamic financial products is that conceptual definitions can give rise to products with differing risk, legal and economic characteristics. In practice, one cannot rely on the labelling of such products, as this is insufficient to determine their actual economic risks and legal and regulatory characteristics.

- **Uncertainty and lack of convergence of Sharī‘ah interpretation:** It is well known that the lack of uniformity in the implementation of Sharī‘ah, where precedent in one jurisdiction may not necessarily be applicable in another jurisdiction, does not provide the certainty and predictability that are so necessary to maintaining confidence. We have seen through litigation that the lack of convergence of Sharī‘ah has led to a situation where any challenge mounted on the basis of failure to comply with Sharī‘ah can affect the legal status of participants in an Islamic financial transaction. While there are aggressive efforts by various international institutions (such as the IFSB and AAOIFI) to develop and promote uniform standards, no comprehensive work has been carried out or studies published to address such inconsistencies or conflict. To date, Sharī‘ah is not bound by precedents, and rulings in one jurisdiction may not be uniformly enforced in others. As a result, the lack of convergence of Sharī‘ah standards may challenge the legal status and distribution among investors in an insolvency situation.

- **Scarcity of Sharī‘ah scholars and professionals in the area of insolvency:** The situation is made worse by the scarcity of Sharī‘ah scholars and expertise, particularly in the area of insolvency. A study for Paris Europlace, an industry group trying to develop Islamic banking in France, says there are fewer than 100 scholars in the world who are qualified to sit on Sharī‘ah boards. Other practitioners estimate there are only about 50–60 scholars. Islamic scholars not only need to possess a deep understanding of Sharī‘ah principles; they are also required to have the relevant knowledge of economics and finance, and to be able to apply that knowledge in an insolvency situation.

- **Need for analysis of the legal, institutional and regulatory frameworks that are in place for conventional bank insolvency, and to assess their applicability to IIFS:** There is a need to assess the extent to which one needs to differentiate between the insolvency rules for a conventional bank and those for an IIFS (and whether or not that is possible), and to examine what other legal, institutional and regulatory frameworks can be developed to address the insolvency of IIFS in an effective and efficient manner. The resolution
framework that is developed for IIFS must be complementary to, and compatible with, the Shari’ah and the value system in which it is rooted. Moreover, an overarching principle is that the resolution system must complement and be shaped by the unique legal, commercial, cultural and socio-political contexts in which the banks operate. This would mitigate any risks of conflict and inconsistencies between national insolvency systems and international standards on insolvency and creditors’ rights, and would indeed go a long way towards garnering wide acceptance.

The challenge, therefore, is to establish a coherent system of insolvency rules and principles that are consistent with the philosophy of Shari’ah and benchmarked against international best practices, by addressing the above-mentioned issues/challenges so as to allow parties that are interested in doing so to manage their risks and plan their dealings with IIFSs. By undertaking the analysis and diagnostics in a comprehensive way, and based on the aspects of insolvency regimes discussed above, we believe that an analytical framework comprised of Shari’ah-compliant approaches to the smooth implementation of insolvency regimes for IIFSs would contribute greatly to the orderly and equitable resolution of such institutions, while maintaining financial stability and minimising moral hazards.
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CHAPTER FIVE

SYNTHESIS OF THE ROUNDTABLE DISCUSSION
CHAPTER FIVE
SYNTHESIS OF THE ROUNDTABLE DISCUSSION

I. Introduction

The Issues Paper and the various commentaries by experts and central bank regulators prompted lively debate on several aspects of putting in place a credible insolvency regime for Islamic financial transactions and institutions offering Islamic financial services. The discussions centered on several fundamental considerations as follows: i) the lack of clarity in documentation of Islamic financial transactions which creates issues in the assignment of obligations and rights; ii) issues related to courts not recognising, and judiciary not understanding, Islamic finance and *Shari‘ah*-based transactions; and iii) the fundamental question of whether insolvency regimes for conventional finance can be applied to Islamic finance.

This chapter aims to summarise the discussions held during the Roundtable Discussion, with specific attention to the question and answer sessions. It consequently provides the participant’s opinions with regard to issues of insolvency regimes for Islamic finance to complement the main Issues Paper and commentary papers written by the experts and the central bankers.

II. Issues in Insolvency Regimes for Islamic Finance

Based on the discussions between presenters and participants, there are four domains of the issues in insolvency regimes for Islamic finance that can be identified. The issues are discussed in detail below.

A. *Issues of Interpretation of Shari‘ah, Lack of Clarity in Documentation of Transactions in Islamic Finance and the Consequent Management of the Legal Risks*

Issue 1: Interpretation of *Shari‘ah*-based contracts

One recurring challenge encountered in many jurisdictions is the interpretation of *Shari‘ah* for the different types of contracts in insolvency situations that can arise in two scenarios: where all of the parties require the transaction to be *Shari‘ah*-compliant or where only one party of the transaction is concerned with the *Shari‘ah*. Hence, there is clear division of the conventional and the *Shari‘ah* concerns in the interpretation of Islamic financing contracts and how they interact with one another. Mr. Yunis’s paper has provided a detailed description of the *Shari‘ah* issues involved in a number of transactional structures, contract structures and financing structures that are used in Islamic finance and where because of the type of structure that has been used, specific insolvency concerns arose. The paper also discussed various approaches in managing the legal risks involved.

In terms of the substance or the form perspective, as explained in quite detail in Mr Yunis’s paper, the issue of finance lease was raised because most of the structures
of the Sukūk that involve leases have used this Ijārah concept where there is a lease structure built into the contract, and the transfer of the ownership from the lessor to the lessee upon the maturity of the Sukūk.

A question raised was whether the structure is actually “wrongly” considered as a finance lease. "Wrongly", because according to Sharī‘ah, the lessor cannot transfer the significant risks to the lessee. Sharī‘ah dictates that the lessor has to retain ownership and the risks related to that ownership. An example is the case of a bank which enters into this type of Ijārah, and leases an aircraft to an airline company. At the end of the contract – say 15 years later – the bank will transfer ownership at a nominal value or $1 or for no consideration. If anything happens to that asset – the aircraft in this case – it is still the responsibility of the lessor. In addition, if that aircraft, which usually requires, for example, a major overhaul, this would be under the responsibility of the lessor, not the lessee. However, this is not the case in a typical conventional finance lease. Hence, the accounting treatment becomes relevant and will shed light on the substance versus the form of the lease. Nonetheless, in jurisdictions where the legal system is not Sharī‘ah-based such as the UK, the courts have construed the terms of the contract based on the specific terms of the contract which says that the governing law is the law of England and not the Sharī‘ah. There is thus limited legislative protection both in conventional and Islamic jurisdictions, and the default position appears to be that conventional law will apply, or if the parties have dealt with it with specific terms in the contract and that contract does not have provisions that conflict with applicable law, then the applicable law (which is the conventional law) would apply.

On different types of contract structures, it may not be possible to draw parallels to the Murābahah structures because the Murābahah is a sales contract, whereas the Ijārah, is a lease contract. In a sales contract, the risks are transferred to the purchaser. Hence, in both types of transactions, the seller, in the case of the Murābahah, or the lessor in the case of the Ijārah, has to acquire the asset. Sharī‘ah does not allow the sale or lease of an asset when you do not, or cannot own the asset. As such, this exposes the seller and the lessor to market risk.

In the Ijārah lease, there would also be the existence of a real estate, a financial asset, a ship or some other asset and the lessor has to retain the risks of ownership. In a real estate transaction, this would mean structural maintenance, insurance and so on. The ownership risk is dealt with by subcontracting that risk back to the tenant under a service agency agreement.

In the case of Sukūk, the Sukūk or certificate holders hold an undivided beneficial ownership of the underlying assets. They are entitled to share in the revenues of the issuer from the Sukūk as well as being entitled to share in the proceeds on the realisation of the Sukūk assets. If the Sukūk holders are only benefiting from the Sukūk assets, either during the term or during insolvency, it is very important to be aware of what those assets are. The issue in this case is that, even though there is a Sharī‘ah-compliant Sukūk arrangement, conventional techniques are used to deal with the Sukūk failure, a restructuring coordinating committee, and so on. Given the preference of Sukūk holders, the transactions are structured as debt under conventional law, while all parties claim to honour the Sharī‘ah statement that there is fractional undivided ownership interest. However, when the issue of ownership rights arise in cases of insolvency or taxation, then Sukūk holders prefer to not have ownership rights.
CHAPTER FIVE: SYSTHESIS OF THE ROUNDTABLE DISCUSSION

Issue 2: Clarity of Documentation and Role of Contracting Parties

Cases cited in Mr Yunis’s paper raised a very important aspect about the role of the rights of the different parties to the contract. In his paper, Mr. Yunis suggested that one possible way to manage the legal risk would be to have a very careful and detailed drafting of the intent of the contracting parties as to how Shari’ah should govern the Islamic financial transaction.

Given the paucity of number of cases in the courts so far, there is little knowledge being built up to give legal effect to the interpretation of Shari’ah contracts. The issue in this case is what more can be done in terms of clarifying the intent? Can there be standard clauses that the international community could agree to that would then guide courts in giving effect to Shari’ah principles in interpreting Islamic transactions? In addition, what can the international community do more to ensure that Islamic finance contracts are given effect to from the intent of the contracting partners so that the prevailing law of the country or the procedures in the law of the country will not undermine the Shari’ah basis of these contracts?

Discussions also focused on property rights, as this is where issues can be most contentious in cases of insolvency. The Sukūk holders are not “owners,” yet they are “supposed to be owners”. This raises the issue of transformation of risk from the seller to the purchaser. This is where, on the default side, the Sukūk holders could have recourse to the assets, given that they are owners of that asset, or will there be contradictions with the law of the land in terms of acquiring those assets when such assets are not in the same jurisdiction.

On a pure and strict interpretation, the Sukūk certificate holder has the undivided ownership of the underlying assets. But in practice, market structures for Sukūk have evolved and replicated the structures in conventional bonds. The documentation of Sukūk has been developed by lawyers. In these Sukūk documentations, just like conventional bonds, the Sukūk holder requires appointment of banks to act as representatives of the Sukūk holders. This practice is adopted in the global Sukūk, where five or six banks such as Deutschebank, Law Debenture, Citibank, etc. have been appointed. They replicate declarations of trusts in conventional bonds, with slightly different provisions. However, the declaration of trust is the same ultimately as for conventional bonds. In this case, the appointed bank acts as the representative of the Sukūk holders.

In other words, ultimately, the representative of the Sukūk holders can appoint someone to take over the underlying asset of the Sukūk and liquidate the asset, and Sukūk holders get their money back. One can argue that at the end of the day, it has been the lawyers who drive the documentation, and hence, the process that determines what the Sukūk holder can do. Although the Sukūk holder has undivided ownership of the underlying asset, his representative can sell these assets, notwithstanding the argument that the sale is in the interest of the Sukūk holder.

There is also an issue of superior rights when hedge funds are involved in an insolvency situation. The hedge fund would purchase the majority of the liability in order to gain superior rights. In the context that Shari’ah which does not allow subordination of debt, what happens when the hedge funds takes over a debt? Given that the hedge fund has superior rights, can there be a confrontation between the rights of the debtor and creditor? Experts view that there is no confrontation between the two, because at the point when debts are sold to the hedge fund, the insolvency has been declared, and nobody is getting paid. There are therefore no debt and no equity, just a class of interests and claims which crystallise after the insolvency is declared.
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Experts are spending a lot of time with the Shari’ah scholars on this issue. Nobody is senior or subordinated in the sense that somebody has a secured position, which is acceptable under the Shari’ah. One of the key principles that allows for a Shari’ah-compliant distressed fund is because in an insolvency case, the creditor does not have a debt or equity. He has a claim at that point, and the claims have not been sorted out. What happens in a settlement of equity is quite different, because some investors might get debt, some might get equity. However, most players prefer equity.

When we link some of the concepts raised by Wan Abdul Rahim, namely the clarity in documentation that will be required for the different types of Islamic finance transactions and the initial suggestions by Mr Yunis in terms of managing the legal risks through clear contractual terms in the documentation – the issue of governance becomes relevant. Mr Yunis suggested that in managing these legal risks, we either have to go through the courts or look at the contracts and define their concepts upfront. Mr McMillen’s point was that while this may sound logical, the issue is that the wishes of the parties are likely to differ from the contracts. The contract may be equity-based, but contracting parties would like resolution to be debt-based. As such, governance tends to change from the time of contract and the time a resolution is being negotiated.

Market forces can also play a role here. Those jurisdictions aspiring to become financial centres for Islamic finance, or even attract Islamic finance, have to put in more effort to ensure that their legal systems cater to the specificities of Islamic finance thereby reducing these uncertainties.

B. Issues Related to Courts’ Recognition of Shari’ah-Based Finance Transactions, Role of Other Stakeholders

Interpretation of Shari’ah-based contracts – the form versus the substance – varies in differing countries due to legal system. The Malaysian solution is an example of how the authorities have facilitated clarity in interpretation by resolving the underlying problems at the court level. In an economy or jurisdiction that has Shari’ah as a big part of that system, Mr. Yunus’s view is that the best way in dealing with the issue is to have some form of supreme governing – Shari’ah Committee as is the case in Malaysia. In a sense, the easiest way to handle questions of Shari’ah is to designate a Shari’ah Committee as the ultimate arbiter of the interpretation. Islamic countries should be encouraged to move towards this legal framework of managing legal risks through the courts.

One way of managing the legal risks is by mandating the courts to hear the advice of Shari’ah scholars. In Malaysia, the regulatory authorities amended the law so the judges have to respect the higher Shari’ah board of either the central bank or the securities commission; so judges in Malaysia are not at the liberty to make their own interpretations. The experts agreed that this approach would be a significant enhancement which will provide a degree of legal certainty in the enforcement of contracts.

However, not all countries are able to take the Malaysian approach. The issue then reverts to the need to have a kind of compromise between the conventional legal system and the Islamic legal system, and how should jurisdictions handle disputes or resolution of a Shari’ah-based transaction? Can disputes be brought to an alternative dispute resolution – the idea of arbitration? Is there another option of creating a special court, which is really just a court, or a special body that has been set up, akin to a commercial Shari’ah court? How would such institutions be built into the legal system in order to ensure credible resolution of disputes for Islamic transactions?
Another related issue is the recognition of Islamic finance by the courts across jurisdictions, particularly between the Gulf, Asia, and possibly Africa. Differences in relation to how the different jurisdictions view Islamic finance in general, and Islamic banking in particular, have created doubts on the value of having a Shari’ah court versus a conventional court. These broader structural issues and underlying legal framework that exist in different jurisdictions have a significant impact on how different Islamic-based financial contracts are treated in these jurisdictions.

In terms of the cross-jurisdictional approach, it is also difficult to have commonality of thinking among all jurisdictions. The problem is mainly that different countries are at different stages of evolution of Islamic finance in their financial markets. Some are very sophisticated in their thinking and may have legal fundamentals to support the political economy and Islamic finance. Some are so advanced that the Shari’ah court is the ultimate arbitrator. Most countries, however, are at the preliminary stages of establishing clear legal framework and regulatory structures, and still have a long way to build a sophisticated legal, institutional and regulatory framework to support the Islamic finance industry.

Given the different stages of development in jurisdictions, the suggestion of having global best practices may be the aim to achieve for Islamic countries in terms of: i) contract and documentation, transactional or otherwise, as well as ii) a standard way of thinking in dealing with illegality, invalidity, conflict of laws, dispute resolution and Shari’ah interpretation.

Notwithstanding the different stages of development among jurisdictions, the international community can have a positive impact in managing legal risks in: i) the cross-jurisdictional-type transaction; and ii) where one party is concerned about Shari’ah compliance but is doing the transaction in a non-Islamic country or in countries where the depth of understanding of Islam is low. The international community can work towards improving documentation standards, ensure that the documentation can give some kind of certainty on how each party's rights are controlled and each party's rights are documented. Because cross-jurisdictional transactions will be limited in this field, the more complex and higher value transactions can probably set a precedent. Parties can contemplate setting a standard on how, for example, how certain interpretive clauses can be built in, and how conflict of laws and differing interpretations of Shari’ah can be dealt with. In the case of very large transactions, there is no reason why good dispute resolution mechanisms cannot be developed. Arguably, the IFSB could be an initiator of this work among the international community, to pull together the views of all stakeholders to arrive at some kind of standard approach to documentation of these contracts.

Another aspect raised is the trend of standards that is evolving outside the transactional universe. Clearly, the transaction cases that are covered in the paper by Mr. Yunis indicate that there are significant developments in terms of evolving standards. However, beyond the judicial and regulatory pronouncements, the role of the IFSB does impact insolvency resolution for Islamic finance. There needs to be more discussions among the stakeholders and how they can influence the evolution of standards and documentation.

At the same time, it is acknowledged that compared to where Islamic finance was not long ago, the Islamic finance industry has developed at light-year speed over the last five to seven years. This is a major achievement. This rapid development of the Islamic finance industry is also attributable to the IFSB, AAOIFI and others that have developed standards that are being adopted on a country-wide basis across regions. Once these common standards are applied in countries, especially so if those countries
can adapt those standards on a global basis — any deviation from these standards by
any one country would need to be justified. Therefore, creating standards which apply
either horizontally or on a vertical basis will support commonality in dealing with cross-
jurisdictional issues in insolvency cases.

This Roundtable, in a sense, is the start of this commonality thinking. Discussions on insolvency/bankruptcy-related cases in Islamic finance are limited because insolvency cases among stakeholders and for Sharī‘ah-compliant transactions are limited. Furthermore, the different stakeholders are not according priority to issues related to the resolution and insolvency of Islamic finance contracts, making such discussions appear as academic or theoretical thinking. However, with the rapid growth of Islamic finance, discussions on insolvency issues need to be pursued with a view to developing guidance for practical implementation.

C. Insolvency of Islamic Financial Institutions vs. Insolvency of Islamic-Based Transactions

Many participants, including the regulators, raised the issue that case studies put forward by the experts covered mainly insolvency issues in relation to Islamic financial transactions. The Issues Paper by Mr. Hamid Yunis predominantly concentrated on the insolvencies of the clients of financial institutions offering Islamic products and had not looked into the issues that regulators may encounter when institutions offering Islamic financial services themselves become insolvent. More work is therefore required on the insolvency of these institutions, especially issues surrounding options for supervisory authorities to intervene to take over the institution before going into insolvency. In the case of the latter, the applicability of insolvency regimes under the conventional banking system to Islamic finance deserves considerable thought, especially in view of regulators’ concerns to protect depositors. In contrast, in a Sukūk or capital market instruments, securities regulators talk about investor protection rather than depositors’ protection, and the securities regulators may not intervene unlike the supervisors for banks (Please see the discussions in the next section).

The presentations and discussions on insolvency cases indicate that the conventional insolvency framework has been applied in resolving insolvency cases related to Islamic finance transactions. This is probably because the Sharī‘ah principles of insolvency by and large are not well-developed, nor well-understood. The issue for the participants of the Roundtable is what concrete steps can be taken to enhance a better understanding of the Sharī‘ah principles for insolvency and their applicability to a modern financial market. Another related question is one that was raised in Wan Abdul Rahim’s paper i.e. whether IFSB should convene an international convention on this matter.

The IFSB’s response was a definitive “no”. The solution is to create awareness of the insolvency issues in Islamic finance and this Roundtable will hopefully facilitate in meeting this objective. The IFSB has been organising a series of seminars on legal framework for the Islamic financial services industry. The last seminar in December 2010, was the fifth in the series, and focused specifically on legal risks. The organisation of these seminars are in response to the observation that the industry was not aware of the significance of the legal risks. In addition to these seminars, the IFSB went one step further by commissioning Michael McMillen, Yusuf Talal DeLorenzo, Hamid Yunis and other experts to conduct surveys and write about some identified legal issues. The papers were presented in the third legal seminar and have been published in a book titled "Islamic Finance: Global Legal Issues and Challenges" in
2008. This approach has resulted in increased awareness on the issues surrounding legal risks. Such issues are now being talked about globally and debated.

The work by the IFSB was spurred by events in the market. There were some defaults. The contracting parties, who until then assumed they had recourse, discovered all of a sudden that this was not the case. That realisation resulted in market participants starting to search and examine the documentation for Islamic finance contracts designed by the legal experts, which few understood. There was also deeper search among contracting parties to seek what were their rights, and whether any recourse was available to them. Based on these experiences, it is clear that awareness of insolvency issues is key to enabling the development and adoption of a good approach in designing insolvency regimes.

The IFSB and the World Bank were urged to undertake further work to enhance awareness and increase the outreach to a wider group of market participants. As a start, the IFSB and the World Bank have compiled the papers that were presented at the Roundtable and are publishing them into this book. In this way, discussions at this Roundtable will not be confined to the Roundtable participants, but will be available to others, facilitating their understanding of the many facets of the insolvency issues. By doing this, IFSB and the WB aims to contribute to building better solutions to address insolvency issues in Islamic finance.

As a further remark, the IFSB clarified that it is not mandated to settle issues through a convention. The IFSB is mandated to create awareness of issues related to risk management, and the legal risks, which have been largely neglected. Due to the lack of awareness among contracting parties and regulators, these issues have been taken for granted. It is only at this time there is a realisation that there is a difference between Shari`ah compliance risk and legal risk. This is the first big outcome achieved creating greater awareness.

Participants were in agreement that the Roundtable is the beginning of the journey to identify the issues and the principles that need to be adhered to, and to initiate a comparative study between conventional and Shari`ah insolvency regimes. There is already substantial standardisation in Shari`ah-compliant contractual documents. However, new issues, which touch on insolvency and the events in the market over the last two or three years, demonstrate areas where the thought process needs to continue. The IFSB has started articulating these issues in many different spheres of the Islamic finance industry. Notwithstanding the work by the IFSB and the presentations at the Roundtable, there are complexities in terms of jurisdiction, Shari`ah interpretation, taxation impact, and so on. August institutions such as the IFSB and the World Bank need to work in partnership to take this work forward.

Michael McMillen viewed that ultimately, we will find that with some modification, the conventional system can be used with appropriate modifications for Islamic finance. Experience in the US showed that market participants can be responsive. The Shari`ah issues were not a concern to participants compared to the issue of whether the Islamic structure is equity or debt in the bankruptcy context. In the East Cameron chapter 11 case, of the creditors, 96 percent were the hedge funds and four percent representing one investor who is concerned with Shari`ah. All the 96 percent creditors (i.e the hedge funds) deferred to protect the four percent creditor in ensuring Shariah compliance resolution. This displayed the existence of a high degree of sensitivity to the whole Islamic finance industry.

The points raised here seem to indicate that in the next steps to carry this work forward, there is a need to involve the whole legal fraternity. It is also important to
remember that there are judges and associations who should also be brought up to speed.

D. Applicability of Insolvency Regimes in Conventional Finance to Islamic finance

Issue 1: Sharing of losses

This is an area where there was consensus for further work. As we attempt to provide analysis of current practices and case studies, Islamic finance can benefit from the new and ongoing work to improve the insolvency regimes in conventional finance. Our work can then adopt what is relevant and applicable in conventional finance to Islamic finance.

This leads to an important part of the discussions – the issue of priority between depositors in conventional finance and investment account holders having to share losses in Islamic finance. Depositors have different status from shareholders in conventional finance as compared to investment account holders who are supposed to share losses with shareholders in Islamic finance.

In accordance with legal arrangements for profit sharing investment accounts (PSIAs) that are Shari’a compliant, depositors should basically bear the losses if losses happen provided that there is no negligence or fraud. However, bank supervisors would not like depositors to absorb the losses as that could have wider implications for the financial system. Bank supervisors would basically like to protect the depositors as that will then ensure stability for the overall financial system. This results in a dilemma. If we strictly follow the Shari’a terms and conditions of the PSIA, then, of course, the depositors should bear the losses; but at the policy level, supervisors do not like the depositors to bear a loss. Hence, the issue of policy response by bank supervisors is the key. Consequently, there is a need to then assess how this policy can be built into the legal framework.

In the case of normal depositors, in the sense of a current account holder, such depositors have priority of claim. However, the question is priority over whom? The investment account holders run pari passu with the shareholders. The current understanding is that in liquidation, the bank distributes the residual value of the assets between the shareholders and the investment account holders, and the depositors of the current accounts have priority over the shareholders’ residual assets. They do not have first priority over the investors or the investment accounts. This aspect is important, because otherwise, it will be non-Shari’a-compliant.

Another important point is the fact that regulators determine that the shareholders of the banks should bear the risk of loss instead of the PSIA holders. This could result in the shareholders taking the regulators to court, especially if they have not been responsible for misconduct or negligence. This is because at the point when the shareholders bought the shares of the bank, they did so on the understanding that the investment account holders’ money or funds needed to be mobilised to bear the risk of loss.

Issue 2: Collective Restructuring Regimes

The discussion on collective restructuring schemes concluded that Shari’a laws view this scheme as improper. Collective schemes involve a group of the biggest creditors getting together to deal with a default case. The creditors negotiate a settlement on behalf of, or implicitly on behalf of, everybody else. Hypothetically, there
can be agreement that the investor takes 80 percent of what is owed to him rather than 100 percent. Further, rather than the debt being repaid over five years, it is repaid over ten years. In arriving at this agreement, some creditors are going to be better able to accept those terms than others. As such, in Shari‘ah, it will seem improper to force acceptance of these collective terms when some investors are financially stronger than others.

The discussions thus far with the Shari‘ah scholars on this point indicate that the majority of scholars view the collective restructuring scheme as improper. The most common reason given is that in Islamic finance, stockholders within a company, on the face of it and constitutionally, should be equal. There cannot be a preferential right in a pure Islamic financing, be it a Mushārakah or Muḍarabah kind of structure.

The second reason raised to support non-acceptance of collective restructuring regimes is that in some circumstances, the scheme forces a person, against their will, to change the terms of their agreement, which is not allowed under Shari‘ah. Therefore, finding ways around to approve collective restructuring schemes has been more difficult than anticipated. In conventional regimes, the restructuring on the whole class can be imposed.

One of the ways in which changes outside of what is permitted constitutionally can be done is by having a shareholders’ agreement. In the same way, these issues can be covered as early as possible by having an agreement between creditors, potential creditors, or lenders or any relevant party involved in Islamic financing, allowing the parties to agree among themselves. The agreement provides that in an insolvency situation, a certain majority of creditors are able to bind all of the creditors. In this case, it is not an issue of going against somebody’s will, as from the beginning there is already an agreement on the kind of vote and operating mechanism. This approach would be better than the approach where creditors have different rights. In the latter approach, there is no “one-off way” in which creditors will be asked to agree to a position after the event.

On the issue of preferred stock, similar to the East Cameron transaction, lawyers spent a lot of time discussing with the Shari‘ah scholars about the process. One of the issues is to assess the preferred option in an insolvency situation, such as periodic payments. Since there is already an insolvency situation, it seems irrelevant to question the preferences. The scholars do not object to one creditor being paid before another when there is an upfront mutual agreement among creditors in the sequence of recoveries. The issue, however, is that creditors are not supportive of documenting these types of terms/understanding into the contract.

**Issue 3: Substance over form**

The main problem facing Islamic finance is this tension between substance and form. This issue surfaces particularly when contracts fail. If there are no issues with the financing, whatever agreement that has been concluded between the parties is acceptable. However, when there is a problem, the question on the rights of the parties and their obligations would arise.

What has happened is that the basis of an Islamic financial product from a Shari‘ah perspective is premised on participation and risk-sharing. This often makes such products not being accepted by central banks and tax authorities as well as the market which views risk transfer (rather than risk sharing) to be important for such products. Such products therefore cannot be offered by a bank but can operate under company law, by forming a company. This in turn results in compromises in the
nominal Shari‘ah contracts to meet requirements set by the banking regulations. In many aspects, these Islamic financial instruments depend on conventional practices, including the method of assessing the time value of money through accepting LIBOR as a benchmark for pricing the transaction.

**Issue 4: Stability implications in debt resolution in conventional and Islamic finance**

The IFSB-World Bank insolvency project aims to follow-up with further analytical work which can provide the background for the IFSB to provide some guidance to central banks on setting up an insolvency regime for institutions offering Islamic financial services (IIFS). This regime may need to cover managing potential insolvency of the transactions, which are insolvencies of clients versus the institutions, and the insolvency of the institutions themselves. However, given that banks are the main investors of Sukūk, they will bear the impact of the risk of Sukūk default. Logically therefore, by according priority to develop guidance for resolution of insolvency at the transaction level as well, the issue of institutional stability will be addressed.

How then can we accord priority in trying to undertake debt resolution? From a central bank perspective, priority would be to resolve the interests of private investors so that Sukūk default would not translate into risk to the depositors in terms of impinging on the asset and liability position of the financial institutions. However, it may also be appropriate if the next steps focus on insolvency issues relating to Sukūk first, and then only on insolvency relating to IIFS. This is because resolutions so far have been of Sukūk-by-Sukūk, which has not resulted in market failure. The impact of Sukūk default so far has not been the same as compared to corporate insolvencies during the Asian crisis, where leveraging by the corporations led to a more systemic financial risks. Hence, if priority was accorded to resolving insolvencies at the transactions level, at the same time develop some kind of early warning on Sukūk failures, it is then probable to prevent multiple Sukūk failures from becoming a systemic issue, thereby containing the impact on the solvency of banks.

This debate is more a sequencing issue in debt resolution. While regulators take pride that higher Sukūk issuances have resulted in risks being diversified away from depositors, this may not be the case. The risks of Sukūk rest with investors, and the holders of Sukūk are largely banks. Hence, banks continue to finance a large share of economic activity. Given the risks of Sukūk defaults, by prioritising attention to insolvency issues relating to Sukūk default, we can prioritise debt resolutions at the transaction level, thereby avoiding market failures and institutional contagion.

Regulators, however, view that the banks’ investments in Sukūk would be addressed through regulatory policies on risk management, concentration limits and the like, especially in light of current insolvency practices where debt is sold to hedge funds and the like. There is always the possibility of the bank selling the Sukūk to potential investors, who would then control the restructuring of a defaulting Sukuk. As such, regulators maintain that the natural stakeholder in priority terms has to be the depositors. Indeed, since the focus of the analytics is very much on developing an effective insolvency framework for financial institutions offering Islamic financial services, it is important to see how we can address this dilemma of deposits that are structured as PSIA investment type products. Yet from a regulatory/protection point of view, PSIA attracts all the features of a deposit. More work on the stability implications of a debt resolution/insolvency framework is therefore needed.

In the context of current regulatory practices in resolving default issues, the IFSB reminded participants of the design of capital standards. In the Capital Adequacy Standard issued by the IFSB, there was initially a standardised formula that gave a
faithful representation of the contractual relationship between the bank and the investment account holders — i.e. all the funds of the investment account holders are deducted from the denominator, because the holders bear the risk of loss, provided it is not due to misconduct or negligence. Subsequently, supervisors gave the feedback that they would not allow such a consequence, and hence, the fairest formula assumed, as per the contract, that these investors bear their own risk of loss. Supervisors then reacted that this practice could lead to investors withdrawing their funds, leading to a systemic risk. Given the central bank’s mandate is promoting financial stability through managing systemic risk, this becomes an issue.

The discussions illustrate the spectrum of the divergence of viewpoint by different stakeholders in the market, and each supervisory authority tends to look at the insolvency issue through its own pair of binoculars. Therefore, while the IFSB has been making progress in its work on this issue, supervisors are still divided on how to address these issues at the institutional level. For example, in the United Arab Emirates (UAE), the large exposure of banks to Sukūk issuances threatened to lead to systemic risks in banks, including the foreign banks. This forced the regulator to undertake intensive stress-tests to determine the extent of systemic risk in the financial system. Another viewpoint is that we need to understand the differences in the situation of the UAE and other jurisdictions. Therefore, given the unique circumstances in the UAE, resolution of the cases there should not create a precedent for the rest of the world.

Going forward, regulators, in their efforts to develop frameworks to manage debt resolutions should not only focus on large Sukūk. Given that Sukūk is becoming more acceptable as a fund-raising instrument, regulators need to look at how the Sukūk market is likely to evolve. It is likely that corporate issuances of $5 billion for each transaction would be rare, and the norm will be issuances of smaller amounts, in the $20 million range. If this is the probable direction that corporations are moving to, the rules on ownership, whether equity or debt, will evolve accordingly. Whether small or large Sukūk issuances, the major issue is determining ownership under the different cases when there is a government covenant in the Sukūk versus a corporate or a bank covenant. Hence, the rules of ownership will evolve around the new smaller transactions. It is for this type of transactions where the purity of the Shari‘ah will be seen in terms of investors having an equity ownership of the underlying asset, and not merely engaged in a debt transaction.

Issue 5: Treatment of debtors in Islamic finance versus conventional finance, when the bank loan or financing faces repayment problems

Wan Abdul Rahim’s paper drew attention to the fact that restructuring is permissible in Islamic finance. The creditor has a duty to allow the debtor time and support to regularise his position to enable him to meet all obligations in the future. For the banking sector, forbearance on a loan going bad is not a recognised practice as the rules on non-performing loans are applied across the board. Therefore, for banks, when forbearance is to be allowed, there must be a directive from the regulator. In situations of systemic instability, there have been precedents where a public policy allows forbearance by banks and lenders across the board. For example, the classification of non-performing loans by Malaysian banks was extended from 90 days to 180 days during the Asian financial crisis. This was a public policy to allow forbearance. In a sense, this public policy is implicitly consistent with what the Shari‘ah would expect in terms of being lenient to debtors that are facing problems. However, it can be argued that in Islamic finance, there is no need for a public policy as the Qur’an provides that you must give time for the debtor to regain his position to repay.
Participants view that this expectation in Islamic finance creates a moral hazard. Furthermore, the requirement in Islamic finance to accord forbearance and to help a debtor facing problems also potentially creates dilemma between the supervisors of conventional banks and the supervisors of Islamic banks. Supervisors of Islamic banks may favour exercising regulatory forbearance in terms of non-performing financing, whereas the conventional supervisors might be view this differently, in that exercising forbearance is just not something that they are prepared to do.

From a regulator’s perspective, the criteria for the recognition of non-performing loans primarily deal with the balance sheet of the bank. Therefore, when a loan (whether an Islamic financing or a conventional loan is categorised as a non-performing after a certain period of time, the bank has to make a provision in its accounts. Regulators therefore do not view any difference in either conventional or Islamic-based loans.

This would be the case in normal times. In practice, when there is a crisis, regulatory forbearance is allowed, regardless of the religious or legal considerations. The supervisory authority should make a decision which would be in line with the stability objectives for the banking system. Hence, there should be a differentiation of approach in crisis and normal circumstances. In the latter case, if the creditor does not want to be “sympathetic” in conventional finance, which is usually the case for fear of impacting their collateral value, they want the debt resolution to be as quick as possible. In the case of Islamic finance, the financier should be exercising forbearance on the debt.

A participant concluded that the principal difference is that in the Islamic perspective, if a person has an obligation, they should then pay their obligation; otherwise, “they go to hell”. On the basis of this principle, lawyers cannot actually bring the cases of forbearance to the court.

In Indonesia, at the institutional level, the bankruptcy approach is not applied, but insolvency is addressed through a liquidation process. If a bank exits from the industry, the regulators then apply the liquidation process and not the restructuring process. This means that first, the private sector will bear the risk. However, if the condition becomes systemic, then the public funds through fiscal expenditure by the state will cover the systemic risk. That is the last resort. If the problem is a liquidity mismatch, then the central bank will handle it.

Overall, the sessions covered many common features in the conventional insolvency framework that can impact on Islamic financial transactions, of course, with many differentiating features. The questions that were raised included whether Shari’ah principles relating to insolvency should be so fundamentally opposed to adopting the broad conventional insolvency framework with the necessary differentiation? Is it necessary that we must develop a special resolution framework for Islamic finance transactions?

Insolvency regimes are not a stand-alone issue. Islamic finance considers the issue of maintaining financial stability as crucial. In the East Cameron Sukūk default, over 90 percent of the assets were acquired by the hedge fund institutions. Recently, there is greater awareness that this practice can result in instability in the financial markets. It was therefore suggested by participants that further discussions on the issue should include legal advisors as well as central bankers, in addition to industry experts, so as to provide perspectives from the economic and financial stability considerations.
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III. Conclusion

The IFSB and the World Bank will discuss and agree on the next steps to follow-up on the issues that have been presented at the Roundtable. Perhaps the next step is to have a detailed workshop on these issues, with detailed presentations similar to those in the Roundtable, from lawyers, SharTah scholars and regulators, which could take this initiative to the next stage. While this Roundtable is for discussion of the broader issues, the proposed workshop should deliberate the details. It is important to further articulate the issues identified in this Roundtable in a very succinct manner. It is necessary to be able to find answers to the issues that will provide clarity and certainty to all stakeholders concerned.
CLOSING REMARKS FROM THE ROUNDTABLE DISCUSSION

EFFECTIVE INSOLVENCY REGIMES: INSTITUTIONAL, REGULATORY, AND LEGAL ISSUES RELATING TO ISLAMIC FINANCE

Tunc Tahsin Uyanik¹

Excellencies, distinguished guests, ladies and gentlemen,

On behalf of the World Bank and the IFSB, I would like to thank all of you for joining this Roundtable Discussion, and for your excellent contributions in terms of your experience and expertise as well as your frankness in the session. Our hope that this would be a good discussion came to fruition, and it came to the point where everybody was very open, and the issues raised were really substantive and critical. Let me say here that I truly appreciate your willingness to share your experience and views. I would also like to thank Professor Datuk Rifaat for his judicious chairing of the roundtable sessions and members of the joint secretariat between the World Bank and the IFSB for their dedication and hard work in organising this event.

The World Bank, as Mr. James Adams mentioned in the beginning, is a new player in Islamic finance. We are coming in with the intention of, first of all, dealing with Islamic finance-related products so that we can use these products for developmental aspects in addressing the development needs in other countries. Secondly, we are partnering with institutions like the IFSB, where we can have an impact on improving the transparency, the broader understanding and the uniformity of the application of the very critical tools and instruments of Islamic finance.

Today, we witnessed a very open and insightful dialogue about the complex legal, regulatory and institutional issues when addressing the resolution of an insolvent Islamic bank that has assets and liabilities based on Sharī'ah. It is evident that practices and approaches across countries are rich and diverse.

As you are well aware, the integration of financial markets has not isolated Islamic finance, and several Islamic financial service providers and instruments were threatened with failure. Some Sukūk have defaulted, largely from the second round effects of the global financial crisis. Wide participation in the Islamic financial markets by both conventional and Islamic financial institutions has raised awareness among policy-makers and market participants that in the event of default by a borrower (which traditionally kicks off legal insolvency proceedings), there is insufficient clarity and certainty of creditors’ claims against the borrower. The current financial crisis has shown the weaknesses in resolution regimes for financial institutions globally. In order to build confidence in the Islamic financial sector which has wide global participation, a set of internationally accepted principles of insolvency for Islamic banks, as a first step, is imperative and timely. Therefore, the challenge before us is to establish a coherent and common system of rules and principles that are consistent with the philosophy of Sharī'ah and benchmarked against international best practices, so as to allow interested parties to manage their risks and plan their dealings with Islamic banks in regard to Islamic financial transactions.

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Several themes have emerged in the discussions of the Roundtable today:

First, the Shari’ah basis for Islamic financial transactions can give rise to different risks, with legal and economic characteristics that are often not reflected in the legal arrangements between the financier and the parties who deal with them in the legal documentation. In fact, it is quite common that many features of conventional banking that is primarily based on a creditor-debtor relationship are retained in Islamic financial transactions even though the contractual relationship between the parties for such Islamic financial transactions is not characterised as a debt.

We have heard from the presentations by Mr Yunis, Mr Mcmillen and other speakers regarding the trend of recent court decisions in several jurisdictions that would not recognise the Shari’ah principles, upon which Islamic financial transactions are structured, particularly in jurisdictions whose legal system is not Shari’ah-based. This can be due to a variety of reasons, such as:

a. Terms and covenants in the transaction documentation seeking to protect creditors’ rights may undermine the Shari’ah basis of the transaction;
b. Courts are more inclined to look at the substance and intent of contracting parties of the transactions rather than the legal form of the contracts. In most cases, the chosen governing law, which is not based on the Shari’ah, may not be appropriate in the determination of the legality and enforceability of the Islamic financial transaction; and
c. The existence of other legal rules and procedures in a national jurisdiction that may negate the conceptual Shari’ah basis of Islamic financial transactions.

In this regard, an important starting point is to deepen the understanding of Shari’ah principles in relation to insolvency; the Shari’ah basis for different Islamic financial transactions and contracts, and the risks that are associated with relationships between the financier and the parties dealing with them under Shari’ah.

Mr Yunis and Mr Mcmillen have discussed in their papers some of the fundamental differences in concepts between conventional insolvency principles and insolvency under Shari’ah. It is encouraging to hear from them that harmonisation with conventional systems is feasible on a wide range of areas and that there are only specific areas where the issues would need to be further explored. Thus far, innovations in Islamic financial transactions have largely been built on conventional legal arrangements where agreements are drafted to reflect the manner in which losses are to be allocated in the event of insolvency.

Going forward, it is clear that much more would need to be done to achieve a deeper understanding of the Shari’ah principles for insolvency. I do think today’s Roundtable is one small step in the right direction in fostering robust discussions and promote international consensus on best practices and approaches that are based on proper risk assessment and understanding of loss allocation arrangements between the different contracting parties under Shari’ah.

Second, a major challenge for Islamic finance is the absence of a minimum level of harmonisation where national legal and regulatory frameworks differ in key areas. For example, in the context of bank insolvency, there is no universally-agreed approach to questions as regards the trigger for the commencement of insolvency proceedings for banks and the powers that are available to the supervisors to deal with insolvent banks. In a cross border situation, the problem is aggravated by national frameworks that ring-fence assets by host jurisdictions because national priorities are translated into a territorial approach that favours the depositors and creditors in the host jurisdiction. One commentator has rightly pointed out that while these are truly the key industry
challenges, we should also not overlook the importance of building the capacity and understanding of Sharī'ah and Islamic finance by bankers, lawyers, judges, regulators and policy-makers.

Third, there is a need to clarify the position of Profits Sharing Investment Account or PSIA in the event of insolvency of an Islamic bank. PSIAs are often pooled investments which are structured as Muḍārabah agreements in that the investor bears the full risks unless there is negligence, misconduct or breach of contract on the part of the Muḍārib. For unrestricted PSIAs where the capital of holders of PSIAs is commingled with the equity of the Islamic bank, would they be given the protection normally given to depositors in terms of ranking? How would Islamic-based deposit insurance, if available, apply to such PSIAs? Some speakers have suggested an approach in defining clearly the rights, obligations and payment priorities of each type of customers of an Islamic bank in the legal framework so that there would be no ambiguity.

Fourthly, a main challenge for the development of Islamic finance is the lack of uniformity in the implementation of Sharī'ah. This is especially true considering that a legal precedent in one jurisdiction may not necessarily be applicable in another jurisdiction. In this regard, much more must be done in enhancing professional capacity including high calibre Sharī'ah scholars if the Islamic financial services industry is to be expanded. Other initiatives are in the area of promoting harmonisation and standardisation in regulatory approaches, definitions, dispute resolution clauses and disclosure of risks.

The World Bank acknowledges the extensive contribution that IFSB has made in the area of prudential standards and AAOIFI in the area of accounting standards. For the World Bank, we are pleased with our partnership with these international Islamic standard-setters in relevant areas.

We have indeed learnt much today from the work of our experts, commentators and participants. The proceedings of today’s Roundtable would be compiled and published with the IFSB and World Bank contributing chapters in the publication. The IFSB and the World Bank would also be undertaking a comprehensive analysis and diagnostics on all relevant legal, regulatory and institutional challenges relating to the effective resolution of insolvent Islamic banks. This would help us in drawing useful lessons and in developing a framework of possible approaches for the effective resolution of insolvent Islamic banks. Experience has shown us that a well designed resolution regime for banks not only allow parties in interest to manage their risks and plan their dealings more effectively, it is also a critical component of financial stability. It is our hope that the comprehensive analysis and diagnostics project would identify the issues and perimeters for the IFSB to develop guidance on principles of effective resolution regimes for Islamic banks for its member countries in the future.

With this, let me once again thank you all for your participation.

*October 10, 2010*
*Washington D.C.*
CONCLUDING REMARKS

The effort of organising a Roundtable Discussion highlighting the inherent issues in insolvency regimes for Islamic finance and possible solutions, and publishing the results, is indeed an excellent and timely initiative by the IFSB and the World Bank. It is hoped this effort will enhance the development and resilience of the Islamic financial services industry (IFSI). The panel contributors for this project include both experts from the industry and senior personnel from the regulatory and supervisory authorities. Hence, the book addresses pertinent challenges, based on the contributors’ practical experience, with a particular focus on the issues that need more and immediate attention from all stakeholders – whether by upgrading existing regulations or by improving current practices in the market. The participation in the Roundtable Discussion of high-profile market players, experts, regulators and supervisors from various countries also served to enhance the quality of the discussions. The sharing of experiences from various jurisdictions provided an opportunity to highlight important issues and stimulate further discussion.

The IFSB-WB Roundtable Discussion was held at the optimum time. The recent financial crisis showed that, in most cases, there is no specific regulatory framework for insolvency in the IFSI, nor any regulation in practice that caters to the industry’s specificities. With no specific guidance on this issue, analysis of the regulatory framework is very much required. An immediate challenge is the need to establish a coherent system of insolvency rules and principles that are consistent with the philosophy of the Shari`ah and benchmarked against the best practices of existing legislation. This task becomes even more challenging when one considers that even in the conventional banking industry it is more difficult to reach consensus on insolvency resolutions than it is to have uniformity in other banking laws and regulations.

Shari`ah Considerations Related to Insolvency

As the operations of the IFSI are underpinned by Shari`ah principles, initiatives to provide a comprehensive insolvency regime for Islamic finance must start by exploring the Shari`ah’s views on insolvency. The basic guidance on insolvency has been mentioned in the Qur’an and addresses both contractual parties: the borrower and the creditor.

Shari`ah indeed requires the parties to fulfil their obligations – it is not only a legal obligation; it is a sin if they fail to do so: “O you who believe, fulfil (all) contracts” (2:280). Further, creditors are recommended to be socially responsible and forgiving: “And if you give freely (i.e., if you forgive the debt voluntarily) it will be better for you, if only you knew” (5:1).

Further explanations and consensus opinions have been provided by Shari`ah scholars that guide the contemporary practices of Islamic finance in the event of insolvency. Some of these consensus opinions are widely accepted, based on the explanations in the Qur’an and Hadith. For example, additional charges for the debt in respect of delayed payments are not allowed, as they are considered as Riba. In addition, the Quranic verse: “…then grant him time till it is easy for him to repay; but if you remit it by way of charity…” could be used as an indication of the preference for debt restructuring, either through time extensions, rebates or haircuts.
In practice, despite Shari’ah recognising insolvency, or Iflas, for both balance sheet insolvency (in which liabilities exceed assets) and income statement or cash-flow insolvency (in which there are insufficient liquid assets to pay debt on a current basis), Shari’ah does not differentiate a Muflis as a bankrupt person or a business entity. Consequently, there is a problem with the concept of limited liability, as owners of business entities are supposed, in theory, to take all the responsibility for the liability of the company.

In order to provide a strong framework for insolvency regimes that cater to the specificities of Islamic finance, more studies of Shari’ah perspectives on the issues are needed. While numerous studies have been made, and a copious literature exists, regarding bankruptcy for commercial businesses, virtually no specific studies have been carried out in the corresponding area of Islamic finance. Consequently, more analytical comparisons of the theory and practice are required. Two stages are envisaged in order to produce comprehensive studies on insolvency from the Shari’ah point of view: (1) identifying the steps in insolvency proceedings required by the existing laws and highlighting cases where these conflict with the Shari’ah requirements; and (2) exploring plausible solutions, if any. Some examples of these efforts have been presented by Michael J.T. McMillen during the Roundtable Discussion and in Chapter Two. But further discussions on this matter by the industry stakeholders are required.

Disputes in Insolvency Regimes for Islamic Finance

Problems that arise in the insolvency regimes for the IFSI, however, are not due merely to inadequate Shari’ah guidance on contemporary insolvency proceedings; rather, they arise more from possible conflicts between the Shari’ah and existing legal systems. For example, the laws of the land where the insolvency case takes place may not recognise Shari’ah in their legal system. And in those jurisdictions where Shari’ah is recognised, there may be no guidance on interaction between Shari’ah and the jurisdiction’s legal system. Problems also arise as a result of differing interpretations of Shari’ah-compliant contracts, thus creating uncertainty and a lack of clarity that face the judge when a case is brought to court. This may result in the courts ignoring Shari’ah and focusing only on the law of the land, as the contracts are registered based on that law.

In Chapter One, Hamid Yunis has listed some of the areas of conflict between the Shari’ah and existing legal systems. An example is the ownership of the underlying assets in asset-backed Sukūk. While Shari’ah principles stipulate that the Sukūk holders shall own the assets, in practice, existing laws may not respect this stipulation. Another example given is the failure by legislation in many jurisdictions to support the process that is required for financial instruments to be Shari’ah compliant – and especially for sovereign Sukūk where the underlying asset belongs to the government.

Another problem in the resolution of insolvency is the fact that Shari’ah-compliant structures are being “forced” to follow the logic of “positive law” as it exists in the various jurisdictions. In order to be compliant with both the Shari’ah and conventional law and regulations in a particular jurisdiction, very complex contracts have to be drawn up. This creates a certain amount of confusion, which Hamid Yunis calls “matter over arrangement” and “form over substance”. The courts, however, particularly in jurisdictions that do not recognise Shari’ah, will look more closely at the substance and intention of contracting parties, rather than the form of the contracts. Nevertheless, all the contributors to this book agree that to ensure that Shari’ah
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While updating the existing regulations may be a long and complicated process, a more practical solution that may help to mitigate problems in the event of insolvency is to ensure that the contractual parties incorporate in the contract all the requirements arising from Shari‘ah principles. It is also very important to define carefully what constitutes an event of default, or a potential event of default, in Shari‘ah-compliant structures and what the consequences might be. The contract would have to be well thought out and carefully drafted, reflecting what would happen and what the rights of the parties would be. Considerations in this regard would have to be taken into account from the initial stages – that is, before executing the contracts.

Insolvency Issues in the Liquidation of Institutions offering Islamic Financial Services (IIFS)

Although there were no known cases of Islamic banks experiencing insolvency during the last financial crisis, discussions of this issue need to be initiated as a matter of foresight in order to prevent complex situations arising in the future. The main untested issues that may arise when an IIFS becomes insolvent and has to be liquidated are related to the investment account holders (IAH). The IAH are usually based on Mudārabah contracts with the banks; they are profit sharing and have to bear all losses for their investments unless the losses are due to misconduct and negligence of the banks.

There is indeed uncertainty and lack of clarity on how IAH will be treated during the insolvency of IIFS. While restricted IAH could be expected to have a first claim to the specific assets in which their funds have been invested, the position of unrestricted IAH is particularly unclear, since their funds are generally commingled with other funds managed by the IIFS. Will the unrestricted IAH, then, be considered as pure depositors/creditors (unsecured), as equity investors (quasi-shareholders) with a residual claim to a share of the commingled assets financed by their funds, or (following the analogy of restricted IAH) as having a first claim to the share of commingled assets (subject to any losses affecting such assets) financed by their funds? A similar uncertainty applies for other contractual arrangements – for example, in a Wakālah, Wadī‘ah or Mushārakah contract on the liability side of the balance sheet of the IIFS. Other issues that will arise include priority in payments, if any, of the various accounts during insolvency and the legal position of profit equalisation reserves and investment risk reserves.

In practice, central banks do not allow the IIFS to transfer all the losses from the investments to unrestricted IAH. Similarly, it could be expected that central banks will not allow unrestricted IAH to bear all the losses on their share of commingled assets during the insolvency of IIFS, but rather require the IIFS to treat them as depositors (i.e. unsecured creditors) not investors. If the legal system does not support the contractual position of profit-sharing and loss-bearing features, the IAH will be treated as depositors, not investors. In the event of liquidation, the IAH may get their investment back, up to the level of the guarantee given by the national deposit insurance.

In addition, investment contracts are structured so that IAH shall receive the full amount of their investments together with any profit that is allocated to their investments. However, the latter is difficult to realise, because most or all of the unrestricted IAH funds are commingled with the shareholders’ funds and other funds...
(such as current accounts) managed by the IIIFS. If there is no transparency in managing and reporting the funds, it will be very difficult to calculate the profit that is rightfully attributable to IAH funds, especially in the event of insolvency.

Another issue relating to IAHs is the matter of corporate governance and IAHs’ rights. For Muḍārabah-based profit-sharing investment accounts, IAH share the profits and have to bear all the losses for their investments unless the losses are due to the misconduct or negligence of the banks. In order to be able to determine if the losses are attributable to negligence or misconduct of the IIIFS, the IAH would need the power to investigate the facts and circumstance pertaining to the IIIFS’s insolvency. However, IAH generally have no such power in practice, with no existing institutional arrangement to represent the rights and interests of IAH. While the relevant supervisory authority will normally take over this role (or in some instances the appointed external auditor of the IIIFS), there is nonetheless a need for guidance and clarity of process on how the determination of the existence of negligence or misconduct is to be achieved in the interests of giving effect to the Muḍārabah rights of the IAH.

Insolvency proceedings may also suffer due to non-liquidation of the financing portfolio. For example, in a Murābahah financing, based on a contractual agreement, the amounts payable under the Murābahah agreement become due only on the contractually-agreed due dates. If the central banks do not take up these future payments for the benefit of IAH, this will negatively impact the insolvency proceedings from their point of view. In addition, the Murābahah receivables cannot be sold for an amount other than their face value. Therefore, there is a lack of incentive for other parties to take over such assets. Selling off the bank’s assets is, indeed, a more general issue in insolvency proceedings for IIIFS. In Ijārah financing, for instance, the issue arises as to when the Ijārah assets may be sold off in the event of the insolvency of the IIIFS. From a Sharī‘ah point of view, among the questions that may arise are: what right would the liquidator of the IIIFS (or the liquidator) have to sell the assets that are being leased to the IIIFS’s clients? Should the clients of the IIIFS be given notice of insolvency? It would be useful if all these issues, though yet to be tested, were clarified through appropriate guidance to ensure Sharī‘ah compliance.

The Way Forward

The Roundtable Discussion has generated a number of issues and challenges which will be carefully studied in order to provide an appropriate framework for insolvency in the case of Islamic financial institutions. The discussion has also highlighted possible solutions and ways to address these issues and challenges. However, more effort in the form of research is needed if we wish to provide practical and technical guidance for every stage of insolvency proceedings. In an interconnected world where transactions do not have borders, close cooperation and consensus among regulatory and supervisory authorities also need to be brought about in order to provide harmonisation and minimise uncertainty in dealing with insolvency.

The task of establishing an insolvency regime for IIIFS faces a number of challenges, as many jurisdictions do not even have specific insolvency regimes for conventional banks. Among these challenges, we can broadly summarise the key areas of focus as follows:

- Considerations related to the specificities of the Islamic finance transactions from both sides of the balance sheet of the IIIFS, with particular focus on IAHs’ rights, which remain untested in the case of insolvency;
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- Potential conflicts between Shari‘ah and existing legal frameworks and how they should be resolved;
- Insolvency proceedings which may contain processes that are not Shari‘ah-compliant.

The initiative of the IFSB and the World Bank in identifying issues in this area is a crucial step in determining the way forward for insolvency regimes for Islamic financial institutions at the international level. As a result of this joint project, the IFSB and the World Bank have agreed to continue this cooperation. Other initiatives will be organised to achieve the objective of assisting the regulatory and supervisory authorities and other stakeholders of the IFSI to develop a comprehensive insolvency regime for the industry which will further contribute to a sustainable and sound growth of Islamic finance.