



Forum Theme: Effective Crisis Management and Resolution Framework

Development of Effective Insolvency Regimes for Islamic Financial Institutions

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ISLAMIC FINANCIAL SERVICES BOARD

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ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 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 includes the issuance of exposure drafts and the 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**.

DEVELOPMENT OF EFFECTIVE INSOLVENCY REGIMES FOR ISLAMIC FINANCIAL INSTITUTIONS

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Introduction

On behalf of the World Bank, thank you for the invitation to be a part of your proceedings today. For us this is both an honour and a daunting responsibility. I say this because we believe that the Islamic Financial Services Board (IFSB) and you, who represent the leaders in Islamic finance, currently have a historic opportunity to provide a framework that could contribute to the full and seamless integration of Islamic finance into the global financial system.

The flow of capital today knows no borders and can be instantaneous; the financial system is indeed global and undergirds the wealth of nations in this increasingly interdependent and multi-polar world. New York and London today stand together with new centres in the Middle East, Latin America and Asia.

Yet it is important to remember that this vast system is still composed largely of small villages and communities. As important as multinational enterprises are, the economies of nations still rely on small and medium-size enterprises and individual entrepreneurship.

Islamic finance, through its notion of shared risk, fairness and ethical conduct, has the unique ability both to support global ventures and to address the financial needs of the poorest in an equitable way. It is because of these core principles that we believe Islamic finance, if effectively integrated into the global system, can indeed make a contribution not only to the stability of that system but to equitable and sustainable development through its core principle of shared responsibility.

The World Bank's mission is to support equitable and sustainable development; and in today's interdependent world of global capital flows, this means that we must also support the integration of diverse economies into the global system. To facilitate an equitable and sustainable globalisation is an essential part of our work. It is because of this understanding of our mission that we appreciate the opportunity you have extended to us of working with you on ultimately similar goals.

The specific topic today – the development of effective insolvency regimes for Islamic financial institutions – is really a way of addressing this pressing and overarching topic: how to achieve the integration of Islamic finance into the global financial system?

As you are the experts in Islamic finance, I will address this topic from the perspective of how current global financial standards work, how they are developed and how they are implemented. With that perspective, you and the IFSB can consider the best approaches in adapting such standards or developing others that address particular needs of Islamic finance.

The World Bank's perspective comes from our decade-long involvement with the Financial Stability Board (FSB; formerly the Financial Stability Forum), a body of G20 financial regulators and finance ministers. The FSB has taken the responsibility of identifying and implementing the 12 core financial regulatory standards that, at the national level, are designed to enhance the stability and resilience of the international financial system. Each of these standards is issued by a designated standard-setting body – the Bank for International Settlements for the Basle Core Principles, for example. The World Bank also participates with other institutions in the standard-setting process for several of these standards and is the designated standard-setting body in the area of effective insolvency and creditor/debtor regimes.

These standards are then used as benchmarks to allow the comparative assessment of national systems with respect to the adequacy of their respective legal and institutional frameworks to manage financial stability and growth. The International Monetary Fund (IMF) and the World Bank together conduct assessments under their Finance Sector Assessment Program (FSAP). These assessments are set out in detailed Reports on the Observance of Standards and Codes (ROSCs) that study national systems using the FSB-endorsed standards as a benchmark. The goal is to encourage implementation of the identified standards at the national level and to help build capacity where gaps are found. The experience gained through these assessments is fed back to the standard-setting process so that the standards themselves are informed by the assessments and can evolve to address the needs of dynamic financial systems.

The World Bank is available to share its experience in this area with the IFSB as it prepares and implements standards for Islamic finance. The one area where we have particular experience as the standard setter and assessor is insolvency and creditor/debtor regimes.

The Growth of Islamic Finance: The Need for Standards

The growth and increased relevance of Islamic finance and Islamic financial institutions in the global financial markets today cannot be overlooked. *Shari'ah*-compliant financial assets have grown from about US\$5 billion in the 1980s to approximately US\$1.2 trillion in 2011.¹ Over the next three years, a 24% compounded annual growth rate in Islamic assets is projected. Islamic banks showed stronger resilience, on average, during the global financial crisis.² Research indicates that adherence by Islamic banks to *Shari'ah* principles accounts for the resilience of Islamic banks in the overall financial system. These principles mandate risk-sharing and ethical conduct in doing business. There are certain standards for the materiality and validity of financial transactions. Credit is available primarily for the purchase of real goods and services. There are restrictions on the sale of debt, short sales and excessive uncertainty; and a prohibition on the sale of assets not owned.³ These factors have generated interest in the international community, with conventional financial institutions looking to explore the potential of Islamic finance as a form of financial intermediation that can promote financial stability.

As Islamic financial institutions expand to new jurisdictions and their share of total financial sector assets increases, Islamic finance will inevitably impact the way global financial markets evolve to support real-sector economic activity. 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 a stable financial system.⁴

A look at the fundamentals of Islamic finance – risk-sharing, the requirement of a real stake or interest in the transaction, and the principle of ethical conduct – suggests the basis for concordance with the conventional financial system. Synergy between the two holds the promise of significant potential for the globalisation of Islamic finance. A renewed attention in the conventional system to appropriate risk-sharing and financial stability should contribute to the goals of equitable economic growth.⁵ As Islamic finance

¹ www.newtimes.co.rw/news/index.php?i=14864&a=11114&icon=Results&id=2

² In terms of profitability, Islamic banks fared better than commercial banks in 2008. However, this was reversed in 2009 when the crisis hit the real economy. Islamic banks' growth in credit and assets continued to exceed that of conventional banks in all countries, except the United Arab Emirates (UAE). Finally, with the exception of the UAE, the change in Islamic banks' risk assessment, as reflected in the rating of banks by various rating agencies, has been better than or similar to that of conventional banks. http://intresources.worldbank.org/FINANCIALSECTOR/Resources/282044-1275491205667/The_Effects_of_the_Global_Crisis_on_Islamic_and_Conventional_Banks_Hasan_Dridi.pdf

³ See http://intresources.worldbank.org/FINANCIALSECTOR/Resources/282044-1275491205667/The_Effects_of_the_Global_Crisis_on_Islamic_and_Conventional_Banks_Hasan_Dridi.pdf, p. 15.

⁴ IFSB and World Bank, *Effective Insolvency Regimes: Institutional, Regulatory and Legal Issues Relating to Islamic Finance*, Chapter 4 by Sau Ngan Wong and James Seward, p. 98.

⁵ Zamir Iqbal and Abbas Mirakhor, *Globalization and Islamic Finance*, p. 26.

converges with the global financial system, it is important to take note of these shared principles and common objectives.

A sound and stable global financial system is key for sustainable growth. The G20 leaders have declared their commitment to ensure that financial markets, products and participants are efficiently and effectively regulated or subject to oversight, as appropriate. In furtherance of this goal, the FSB and various standard-setting bodies have set out actions for strengthened transparency and accountability, enhanced regulation, promotion of integrity in financial markets and reinforcement of international cooperation.⁶

The World Bank, in its commitment to “inclusive globalisation”, supports initiatives that encourage balanced global growth and financial stability.⁷ In the area of financial and private-sector development, an important part of the Bank’s strategy for sustainable growth is to increase the resilience of developing countries’ financial systems through the adoption of better tools for managing financial crises. An important area of focus is providing support to countries that are attempting to develop effective insolvency regimes. Moreover, the financial crisis has emphasised the need for effective resolution systems for all financial institutions which safeguard global financial stability and minimise moral hazard.

In this regard, effective insolvency and creditor rights systems are vital to stability in commercial relationships and financial systems. Moreover, effective creditor/debtor regimes advance important social objectives, such as enhancing public confidence in the corporate and financial sectors. Effective insolvency and creditor/debtor regimes generally enable market participants to more accurately price, manage and control default risks and corporate failure. Effective regimes encourage sound credit practice and promote responsible corporate behaviour by encouraging higher standards of corporate governance, including financial discipline, to avoid the consequences of insolvency. Moreover, modern insolvency systems allow for rehabilitating financially distressed but viable enterprises, while enabling reallocation of assets to more efficient market users through efficient liquidation systems, thereby creating conditions conducive to preserving employment.

In order to have an effective and workable interface between Islamic financial institutions and the global financial system, a number of issues need to be resolved. For example, the wide participation in Islamic financial markets by both Islamic and conventional financial institutions has highlighted that, in the event of default by a borrower, there is

⁶ www.financialstabilityboard.org/publications/r_090925a.pdf

⁷ <http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,print:Y~isCURL:Y~contentMDK:22329105~pagePK:64257043~piPK:437376~theSitePK:4607,00.html>

insufficient clarity on the ranking and status of claims (i) of creditors against the borrower, or in respect of other Islamic financial transactions; and (ii) between the participants in the transaction.

Having in place an effective framework for insolvency regimes of Islamic financial institutions is important to ensure stability of the Islamic financial markets, as well as for sustainable development and growth. As the IFSB begins efforts towards standard setting, it will be important that the perspectives of both economic growth and financial stability are considered. It is also important that the standard-setting dialogue include all stakeholders, such as central banks, legal and accounting experts, the judiciary and industry participants. An essential first step will be an assessment of the applicability of conventional insolvency principles and financial stability standards, which can pave the way for integration of Islamic finance into the global financial system. For example, the *UNICTRAL Legislative Guide on Insolvency Law* and the *World Bank Principles for Effective Insolvency and Creditor Rights Systems* can facilitate and provide guidance on the essentials of an effective insolvency regime. Other internationally accepted standards that include references to effective resolution of financial institutions are: the *Key Attributes of Effective Resolution Regimes for Financial Institutions*; the *Basel Core Principles for Effective Banking Supervision*; the *European Union Directive on and Regulation on Insolvency*; and the *Core Principles for Effective Deposit Insurance Systems*. A joint World Bank–IMF report, titled *Overview of the Legal, Institutional, and Regulatory Framework for the Resolution of Bank Insolvency*, should also be considered. In conducting the review of the applicability of conventional principles, it will be important to draw on the knowledge developed by the IFSB, the Accounting and Auditing Organisation for Islamic Financial Institutions and *Sharī'ah* scholars.

A critical second step will be to prepare a comprehensive and authoritative concordance between Islamic financial products and practices on the one hand, and the conventional system on the other. The existence of such a standard concordance will help issuers and investors, as well as courts, by framing expectations and providing for predictability in enforcement.

The World Bank is looking forward to collaborating with the IFSB in the insolvency area. A concrete initial contribution of the collaboration could be undertaking an analysis of existing financial standards in a comprehensive way on all aspects of insolvency affecting Islamic financial institutions. The collaboration between the IFSB and the World Bank, among other things, would be aimed at providing policy-makers and regulators a sound analytical framework for evaluating approaches that are consistent with *Sharī'ah* and benchmarked against international best practices.

The framework for conventional insolvency regimes, should, for the most part, be generally applicable to Islamic financial institutions. There are, nonetheless, areas where adaptation will be required. Preliminary research indicates, however, that only specific aspects of the insolvency framework for Islamic financial institutions may need to be modified vis-à-vis the conventional insolvency framework. The unique characteristics of Islamic finance and the relationships between these institutions and their customers would have to be taken into account. The task before us now is to identify specifically, and reconcile, the potential areas of divergence in the development of effective insolvency regimes for Islamic financial institutions consistent with existing international standards.

Insolvency Regime for Islamic Finance: What are the Issues?

Much more needs to be done to enhance our understanding of insolvency issues that impact Islamic financial institutions and Islamic finance transactions. The following discussion is an attempt to present some pertinent issues that we view as significant in the analysis of insolvency issues for Islamic financial institutions.

1. CONCEPTS UNDERLYING ISLAMIC BANKING ASSETS THAT HAVE IMPLICATIONS FOR INSOLVENCY

A number of issues specific to insolvency of Islamic banking have to be analysed and a consensus reached. Compliance with *Sharī'ah* gives rise to legal relationships between Islamic financial institutions and the parties who contract with them that are different from such relationships in conventional finance. Since the fundamentals of title, ownership and possession of Islamic banking assets are distinct from those of conventional banking assets, it has transpired that different courts approach the concept of ownership and possession differently. This exposes Islamic banks and banks providing Islamic banking services to uncertainty, thereby making assessment and management of associated risks very difficult. Some of the pressing gaps that need to be addressed include: (i) determination of whether an insolvent debtor in a *Murābahah* real estate transaction can disclaim the unexpired portion of the *Murābahah* lease, which would cause the possession property to revert to the financial institution as landlord, and determination of the impact of such transactions in the event of insolvency of an Islamic financial institution; (ii) clarity on the position of the Islamic financial institutions in control of the clients' business; and (iii) clarity on the protection of assets by the official administrator upon assuming control of insolvent financial institutions and the transfer of such assets to prospective investor(s). Moreover, consensus between *Sharī'ah* scholars has to be achieved on the concept of an entity with a separate legal personality and clarity on the legal personality of the borrower, because, currently, the uncertainty can

be used as a basis for avoiding legal liability and for perpetrating fraud.⁸ A unifying set of standards that complement sound insolvency principles on all of these issues can help the growth of Islamic finance in the long term.

2. INTERPRETATION OF *SHARĪAH*-BASED CONTRACTS, LACK OF CLARITY IN DOCUMENTATION OF TRANSACTIONS IN ISLAMIC FINANCE AND THE CONSEQUENT MANAGEMENT OF THE LEGAL RISKS

Interpretation of *Sharī'ah* for the different types of contracts is another recurring challenge when questions of insolvency arise. There is a clear division of the conventional and *Sharī'ah* concerns in the interpretation of Islamic financing contracts and how they interact with one another. Although progress has been achieved in standardisation of *Sharī'ah*-compliant contracts, some issues that touch upon insolvency of the obligor have yet to be resolved. For example, when questions regarding the actual structure of different financing contracts arise, courts tend to use conventional law in characterising the legal rights and obligations of the parties.⁹ This poses an additional challenge for managing legal risks and determining the rights of stakeholders in Islamic financial institutions, including in the event of insolvency of such institutions. Furthermore, determination of property rights, and the issue of superior rights in an insolvency situation, tend to be contentious. For example, since *Sharī'ah* does not allow subordination of debt, experts need to determine what happens when hedge funds take over debts.¹⁰ *Sharī'ah*-compliant measures incorporated in the insolvency framework for Islamic financial institutions to address this issue should also complement international best practices. 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.

Clarity in documentation for different types of Islamic finance transactions should facilitate management of these legal risks. Research is needed on mechanisms that give effect to the intent of the contracting parties so that the prevailing law of the country or the procedures in the law of the country will not undermine the *Sharī'ah* basis of these contracts. Research is also needed on standard clauses that the international community can agree upon, which could serve as a guide for courts and practitioners in giving effect to *Sharī'ah* principles while interpreting Islamic transactions.¹¹

⁸ IFSB and World Bank, *Effective Insolvency Regimes*, op. cit., Chapter 4, pp. 106–107.

⁹ *ibid*, pp. 115–117.

¹⁰ *ibid*, pp. 117–118.

¹¹ *ibid*, pp. 115–118.

3. UNCERTAINTY AND LACK OF CONVERGENCE OF *SHARĪAH* INTERPRETATION

Even in jurisdictions that give effect to *Sharī'ah* and *Sharī'ah*-compliant finance transactions, interpretation and implementation of *Sharī'ah*-based contracts vary. The certainty and predictability of *Sharī'ah*-compliant transactions can be undermined when *Sharī'ah* scholars in one jurisdiction dispute precedent established by a scholar in another jurisdiction. The inconsistencies and conflicts need to be identified and, perhaps, global best practices formulated to provide guidance on documenting Islamic finance transactions, and on dealing with illegality, invalidity, conflict of laws, dispute resolution and *Sharī'ah* interpretation. Dispute resolution alternatives also need to be given due consideration in the event of distressed *Sharī'ah*-compliant transactions to ensure credible resolution of debtors' and creditors' rights.

4. INSOLVENCY OF ISLAMIC FINANCIAL INSTITUTIONS VS. INSOLVENCY OF ISLAMIC-BASED TRANSACTIONS

Regulators may encounter certain issues when institutions offering Islamic financial services themselves become insolvent. In particular, there are issues surrounding options for supervisory authorities to intervene to take over the institution before going into insolvency. The applicability of conventional insolvency regimes to Islamic finance needs to be given careful consideration in light of the debate over depositor protection vis-à-vis investor protection.

5. APPLICABILITY OF INSOLVENCY REGIMES IN CONVENTIONAL FINANCE TO ISLAMIC FINANCE

Tension between substance over form of different financial structures and instruments also needs to be given due consideration. The fundamental requirement of risk-sharing in Islamic finance transactions gives rise to risks that are distinct from risks that arise out of conventional financial transaction. Risk is, in principle, shared under *Sharī'ah*; however, *Sharī'ah*-compliant transactions are structured so that they are in form compliant with prudential and tax requirements. As discussed earlier, the lack of convergence in interpretation gives rise to uncertainty and makes management of risks more challenging. Guidance should be provided so as to reduce ambiguities and points of contention during insolvency proceedings.

Guidance over the issue of priority between depositors in conventional finance and investment account holders has to be developed. This also goes to the core of the difference between the two financial systems; thus, it necessitates determination over priority of the parties. For example, rights and obligations of the account holder and the

Islamic financial institution in terms of profit-sharing investment accounts¹² (PSIAs) have to be dealt with from the insolvency perspective. Determination by regulators of who should bear the risk of loss is of great importance.

Collective restructuring schemes are considered improper under *Sharī'ah*. Regulators, in framing the framework for insolvency of Islamic financial institutions, need to determine whether a shareholder agreement may provide resolution for use of collective restructuring schemes by Islamic financial institutions.

Institutional stability can be addressed by developing guidance for resolution of insolvency at the transactional level as well. Given the risks of default of *Sukūk*, prioritising debt resolution at the transactional level can mitigate market failures and institutional contagion.

Conclusion

The shared values of risk-sharing, ethical conduct and responsible exercise of forgiveness provide a workable interface between insolvency regimes of Islamic financial institutions and the conventional financial system. There is a consensus among all stakeholders that mechanisms for the orderly and equitable resolution of insolvency of Islamic financial institutions, and for the equitable treatment of Islamic finance products in accordance with their terms, are essential. Comprehensive analysis and diagnostics have to be undertaken on the basis of the issues identified above, and at this Forum for the development of an effective insolvency regime for Islamic financial institutions. Internationally accepted standards and global best practices, as well as Islamic *Fiqh* and *Sharī'ah*, provide principles and guidance to facilitate the development of an effective framework for insolvency of Islamic financial institutions. The World Bank Group welcomes initiatives to facilitate research, cooperation and collaboration towards developing an analytical framework for an effective insolvency regime for Islamic financial institutions.¹³

¹² 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 *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*.

¹³ The Bank's support is premised on the principles of its engagement in the Islamic Finance/World Bank Strategy and Work Programme.



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