

16th Islamic Financial Stability Forum

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

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16th IFSF : Speaker & Discussants

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

16TH ISLAMIC FINANCIAL STABILITY FORUM

11 DECEMBER 2017

KUALA LUMPUR, MALAYSIA

MICHAEL J.T. McMILLEN

- Focus on a **few practical issues relating to the implementation of a recovery and resolution regime** that is responsive to Islamic financial institutions.
- A **select group of issues, posed as questions (without answers)**, and presented to generate thinking and discussion.

OBJECTIVE

- Two important threshold concepts:
 - Recovery – Resolution
 - Bankruptcy – Insolvency

THRESHOLD CONCEPTS

RECOVERY AND RESOLUTION

- **Recovery:** of capital or liquidity position:
 - Recapitalization.
 - Reorganization.
 - Restructuring.
 - More harmonious with Shari'ah principles.
- **Resolution:**
 - Stabilization.
 - Winding down and liquidation.

SYSTEMS: BANKRUPTCY AND INSOLVENCY

- **Bankruptcy:**
 - Debtor orientation.
 - Reorganization and preservation of the business.
- **Insolvency:**
 - Liquidation for creditor benefit.
- **Where on the continuum is a given system?**

Bankruptcy

Insolvency

- **Can the system be used to effect a more bankruptcy-like approach?**

- Shari'ah expertise
 - Regulatory authority
 - Contracts
- Asset sales
- Lender of last resort facilities
- Regulatory authority powers
- Recovery plans

RECOVERY

SHARI'AH EXPERTISE - REGULATORY AUTHORITY

- Working paper makes suggestions regarding the recovery and resolution regime and framework for Islamic financial institutions and countries in which they operate.
- **Most jurisdictions, a single resolution authority** will have jurisdiction over both Islamic and non-Islamic institutions.
 - National **deposit insurance providers** are emerging as the preferred regulatory supervisory authority.
- In most instances in mixed systems, it is likely that **Shari'ah knowledge and experience is either absent or inadequate** in the regulatory supervisory authority.

SHARI'AH EXPERTISE - REGULATORY AUTHORITY

- **Internal or External?**
- **Internal:**
 - How to hire and train internal experts?
 - Budgetary, political, and other constraints?
- **External:**
 - Legal foundation to hire?
 - Criteria and qualifications?
 - Governance, and authority of external advisors?
 - Budgetary, political, and other constraints?

SHARI'AH EXPERTISE - CONTRACTS

- **Classification of contracts will be critical.**
- **Equal treatment for equal risk positions** is fundamental.
 - Equity absorbs losses first.
 - Then subordinated debt.
 - Then unsecured creditors.
 - Depositors last.

SHARI'AH EXPERTISE - CONTRACTS

- **Who will classify** Shari'ah-compliant instruments and arrangements?
- **What criteria** will be used to classify Shari'ah-compliant instruments and arrangements?
- **Should a standard setting organization** within the Islamic finance industry take the lead in classifying instruments and establishing criteria and methodologies?
- Consider profit sharing investment accounts, among others. Are these to be investment contracts with no claim on bank assets? Jurisdictional variations.

ASSET SALES

- Given the size of the Islamic finance industry, it is quite possible that **all Islamic financial institutions will be experiencing a major stress event simultaneously.**
- Sales of assets (of a distressed institution) to other Islamic financial institutions and bridging arrangements with other financial institutions will then be unlikely or impossible.
- A possible solution involves asset **sales to non-Islamic financial institutions.**

ASSET SALES TO NON-ISLAMIC INSTITUTIONS

- **What issues** arise if assets sold to non-Islamic institutions and how are they to be addressed?
 - Potential purchasers: banks; investment funds for profit sharing investment accounts. **Commingling** of funds.
 - Ensuring **on-going Shari'ah compliance**? Who and how?
 - **Contract novation issues** and **preservation of Shari'ah compliance**.
- **Should standards be developed?** If so, what effect on valuations and pricing of the sold assets?
- How to address the **illiquid asset problem** (real estate, ijara, household financing)?

ASSET SALES OF DEBT OBLIGATIONS

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

LENDER OF LAST RESORT

- Stress resolution and recovery frequently entails resort to the lender of last resort.
- Liquidity crises are the most common stress.
- There are very **few Shari'ah compliant lenders of last resort.**
- Existing lender of last resort facilities are interest-based and not Shari'ah compliant.
- Only six countries have Shari'ah-compliant facilities.

LENDER OF LAST RESORT

- As a matter of transition, when, if ever, can Islamic financial institutions **utilize non-Islamic lender of last resort facilities** under doctrines of **necessity**?
- If so, how can an Islamic financial institution utilize non-Islamic lender of last resort facilities?
- **What factors are relevant** to this inquiry?
- **What constraints** should be implemented in these scenarios (if they can be used at all)?

LENDER OF LAST RESORT

- Reserve accounts may work.
- Central bank facilities are interest-based. Qard? Murabaha?
- Mudaraba arrangements: central banks taking equity risk, which exposes public credit.
- Access of Islamic financial institutions to central bank open market operations.

REGULATORY AUTHORITY POWERS

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

REGULATORY AUTHORITY POWERS

- Should **Shari'ah considerations** be constraints on authorities?
- How would the **constraints** be determined (**by whom and when and by what mechanism**)?
- How would the **legal mandate** be obtained and implemented?
- Could the regulatory supervisory authority **change the Shari'ah scholars** advising the Islamic financial institution?
- Should a **standard setting authority within the Islamic finance** industry take the lead in trying to develop criteria or standards in this regard?

RECOVERY PLANS

- Each financial institutions should develop (and stress test) a recovery and resolution plan.
- They are individualized to the institution, in large part.
- The must be responsive to each institution's systemic footprint, business model, risk profile, and organizational structure.

RECOVERY PLANS

- Should one of the **standard setting bodies within the Islamic finance industry** establish a consultative body to assist Islamic financial institutions in preparing RRP?
- **What degree of standardization** should be attempted across institutions (recognizing the ultimate individuality of an RRP as to structure, risk profile, systemic footprint, etc)?
- **What types of factors, if any, should be standardized (or at least harmonized generally)?**
 - For example, with respect to changes in Shari'ah governance or Shari'ah rulings? These types of factors are not relevant for non-Islamic institutions. Are they appropriately considered?

- Resolutions
- Liquidation – investment accounts
- Liquidation – profit smoothing
- Sukuk and capital markets
- Sukuk and true sale

RESOLUTION

RESOLUTIONS

- Bail-ins: cancel shares, dilute or transfer shares, write down claims of unsecured creditors.
- Some Shari'ah structures that constitute equity are amenable (musharaka). No contingent convertible (CoCo) sukuk as yet.
- Write downs are difficult: need creditor consent.
 - ISRA concerns on wa'd or ijara – looks like a loan combination.
 - Can an expediency exception be used (e.g., for sukuk)?
 - What criteria would be applicable and how effected and enforceable?
 - Hiwalah (assignment to another debtor): both sides of balance sheet.

LIQUIDATION - INVESTMENT ACCOUNTS

- Profit sharing investment accounts: restricted and unrestricted. Often mudaraba arrangements.
- Attention to **placement in the creditor hierarchy: equity or deposit** (for example). For both principal and returns.
- Should they **be excluded from the bankruptcy estate** of the Islamic financial institutions? Shari'ah principles perspective.
- **Or** should they be **within the bankruptcy estate but provided a preferred (deposit) distribution?** Public policy perspective.
- **Unrestricted: commingling** raises difficult issues.

LIQUIDATION - PROFIT SMOOTHING

- Profit smoothing reserves: profit from an earlier period.
 - PER: Profit equalization reserves: contains both bank and customer profits.
 - IRR: Internal risk reserve: all customer funds (after bank share taken)
- **Should public policy make these available to bank's creditors? Or only to investment account holders? Are investment account holders "depositors"? Related questions.**
- Different treatment: may need agreed ratios to treat PER reserve.
- Clear guidance to liquidation court or authority is needed.

SUKUK AND CAPITAL MARKETS

- Two different sets of issues:
- **True sale issues** (minimal discussion in Working Paper).
- **Capital classification issues** (CET1, AT1, T2; which are discussed in the Working Paper).
 - Working paper section 3.4.2.1 for types of structures (CET1, AT1, T2), particularly regarding conversion to equity.
 - Shari‘ah compliant structures may cross category boundaries. Example, whole business wakala and mudaraba sukuk (AT1 or T2) have musharaka characteristics (CET1).
 - Need to focus on these considerations.

SUKUK AND TRUE SALE

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

SUKUK AND TRUE SALE

- **Not a true sale: Bank issued sukuk: Will be general obligations of bank.**
 - Unsecured general obligations.
 - Nominally secured but unperfected obligations.
 - Write downs: the bank's repurchase obligation might be written down.
 - But this would require sukuk holder (creditor) consent under the Shari'ah principles. Even pre-consents are problematic: combining a loan with a sale.
- **As an industry, we need to focus more on true sale considerations.**

CONCLUSION

START NOW AND COORDINATE

SHARI'AH BOARD PARTICIPATION

- Shari'ah board participation at two levels:
 - Regulatory supervisory authority (resolution authority).
 - Individual Islamic financial institutions.
- Must be involved from the beginning: to develop a resolution and recovery plan that can be implemented immediately in a stress scenario.
- Should the regulatory supervisory authority have its own Shari'ah board that acts throughout, including during the recovery and resolution proceedings?

STANDARD SETTING ORGANIZATIONS

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

THANK YOU