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Resolution Frameworks for Islamic Banks

By Elsie Addo Awadzi, Carine Chartouni, and Mario Tamez

I N T E R N A T I O N A L M O N E T A R Y F U N D

IMF Working Paper

Legal Department¹

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Abstract

Islamic banking is growing rapidly and its potential impact on global financial stability cannot be underestimated. International standards for resolving banks have evolved after the global financial crisis, culminating in the Financial Stability Board's ("FSB") *Key Attributes of Effective Resolution Regimes for Financial Institutions*. This paper examines the applicability of the Key Attributes to the resolution of Islamic banks. It concludes that a number of issues would need to be addressed, owing to Islamic banks' unique governance structures and balance sheets. It recommends international guidance for the design of robust *Shari'ah*-compliant resolution frameworks for jurisdictions with Islamic banks.

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I. INTRODUCTION

1. **This paper discusses the design of legal frameworks for the resolution of Islamic banks.**² Specifically, it examines the extent to which international best practices for the design of bank resolution frameworks may be applicable to Islamic banks, and whether they need to be modified to take into account the specific features of Islamic banking.
2. **Islamic banks are gaining global systemic relevance.** The activities of institutions providing *Sharī'ah*-compliant banking services have grown rapidly over the years among Muslim and non-Muslim countries, and are becoming an increasingly important component of the global financial system. The failure of a large Islamic bank could therefore have a significant impact on global financial stability.
3. **Islamic banks are not immune to the risk of failure, and legal frameworks for their resolution are required.** While certain characteristics of Islamic banks are likely to reduce the overall risk of failure (e.g. risk sharing, and conservative approach to investment), Islamic banks are as vulnerable to crises as conventional banks. Multiple Islamic financial institutions including banks have experienced financial distress in the last two decades, requiring responses by national authorities. It is therefore important to ensure that countries with Islamic banks have in place legal and regulatory frameworks that will facilitate their orderly resolution.
4. **The design of bank resolution regimes must meet international best practices.** The prevailing international standard for the design of bank resolution regimes is the Financial Stability Board's (the "FSB") *Key Attributes of Effective Resolution Regimes for Financial Institutions* (the "Key Attributes" or "KAs"). The KAs set out a non-binding standard that seeks to ensure that national resolution regimes give the authorities the power to resolve financial institutions in an orderly manner without taxpayer exposure to losses, while maintaining continuity of their vital economic functions. This requires that shareholders and unsecured and uninsured creditors absorb losses and avoid reliance on public solvency support. The KAs provide a set of core elements for resolution frameworks to achieve this outcome. These include the designation of a specific resolution authority that is entrusted with the powers to take control of a troubled institution, and to resolve it using a broad range of tools including mandatory recapitalization, forced mergers, debt restructuring, and transfer of assets and liabilities.
5. **The question however arises whether these best practices are applicable to the resolution of Islamic banks.** While the Key Attributes do not exclude their application to

² "Islamic banks" as used in this paper, broadly refers to institutions set up as Islamic banks as well as Islamic banking windows of conventional banks (whether these are outsourced or carried out in-house).

Islamic banks, they were developed by jurisdictions with predominantly conventional banking systems, and make no special provision for Islamic banks. The special characteristics of Islamic banks, however, require a determination as to how conventional resolution regimes could be applied to them. The need to assess the applicability of conventional resolution regimes to Islamic banks has been a recurring theme in recent discussions at the Islamic Financial Stability Forum of the Islamic Financial Services Board (“IFSB”).³

6. **In examining this question, several important caveats are in order.** In particular:

- The legal and policy frameworks for bank resolution in many countries with Islamic banking systems are, as a general matter, not well developed. Whether for conventional or Islamic banks, very few of these countries have put in place specialized resolution frameworks, and others have relied on their general corporate insolvency frameworks. To the extent that more specialized bank resolution frameworks have been established, they do not distinguish between conventional and Islamic banks. The one notable exception to this approach is Malaysia, whose Islamic Financial Services Act (Act 759) was enacted in March 2013 with a specific resolution framework for Islamic banks.
- Very few countries with Islamic banking systems have experience in resolving Islamic financial institutions. Faced with the potential failure of a financial institution, most countries have chosen to provide public financial support to the institution, to preserve financial stability. This has particularly been the approach taken in the last two decades.⁴ There have been a few exceptions to bail-outs, however, such as in Malaysia, which in 1997, implemented a rescue scheme that forced mandatory mergers of several banks. Another example is Turkey where Ihlas Finans was resolved (February 2001) under general

³ See for example, H.E. Dr Zeti Akhtar Aziz “Financial Reforms in Response to the Global Financial Crisis: Lessons for Islamic Finance in Ensuring Financial Stability”, Seventh Islamic Financial Stability Forum; Doha, Qatar–7 April 2013; Paul Koster, “Crisis Management in the Islamic Financial Services Industry” Fifth Islamic Financial Stability Forum Manama, Bahrain–29 March 2012; and Vijay Tata “Development of Effective Insolvency Regimes For Islamic Financial Institutions” Fifth Islamic Financial Stability Forum Manama, Bahrain–29 March 2012.

⁴ E.g., Dubai Islamic Bank; Kuwait Finance House; al-Rajhi Bank in Saudi Arabia; Islamic al-Hilal Bank in Abu Dhabi; and Noor Islamic Bank of Dubai.

corporate insolvency law,⁵ and Bank Asya is currently (since May 2015) being resolved under the general bank resolution framework.

- Any assessment of the compliance of particular resolution tools with *Sharī`ah* principles is constrained by the possibility of different interpretations of the *Sharī`ah*, by the different Islamic schools of jurisprudence (*madhahib*). This will undoubtedly affect some of the matters discussed in this paper, for example, how different assets and liabilities are characterized in various jurisdictions. Also, what may be regarded as permissible according to one *Sharī`ah* scholar might be considered otherwise by another scholar. Such uncertainty may have implications for the prompt resolution of an Islamic bank with sufficient assurance that the relevant transactions are compliant with the *Sharī`ah*. The design of the bank resolution framework should therefore address and minimize this risk.
- Particular challenges arise with the design of a resolution framework for countries that have both conventional and Islamic banking. Subject to the legal and regulatory framework, entities that undertake Islamic banking activities may take the form of either a full-fledged Islamic bank and/or an Islamic window in a conventional bank. Moreover, many jurisdictions (such as Indonesia and Malaysia) also license Islamic banking subsidiaries of conventional banks. Whatever the case, when such Islamic banking activities are operated alongside conventional banks, the interaction between the conventional regime and the Islamic banks/windows will have to be carefully calibrated in the resolution framework.

7. **This paper examines the extent to which resolution frameworks for conventional banks would be applicable to Islamic banks.** It identifies a range of legal issues that could be relevant in Islamic bank resolution, and which would need to be addressed to help promote financial stability in jurisdictions that have, or are exposed to, Islamic banking. Given the dearth of existing work in this area, this paper only seeks to provide an introductory discourse on the key issues.

8. **The remainder of this paper is structured as follows:** It examines the distinctive features of Islamic banks, after which it analyzes a number of resolution issues including institutional frameworks, and the applicability of several types of resolution tools in an Islamic banking context. The paper ends with a few broad recommendations.

⁵ Ali, Salman (2007), “Financial Distress and Bank Failure: Lessons from Closure of Ihlas Finans in Turkey,” *Islamic Economic Studies*, Vol. 14, No. 1 & 2, Aug. 2006 & Jan. 2007, pp.1–52. Available at <http://www.irti.org/English/Research/Documents/IES/086.pdf>

II. SETTING THE STAGE: WHAT'S DIFFERENT WITH ISLAMIC BANKING AND WHY DOES IT MATTER FOR RESOLUTION?

9. **While Islamic banks share common characteristics with conventional banks, there are a number of features that set them apart.** Islamic banks, like conventional banks, are typically incorporated and organized as corporate entities with legal and contractual powers to engage in banking business, and are subject to regulation and supervision as such. That said, a number of their characteristics, including their religious nature, governance structure, and balance sheets, make them quite distinct from conventional banks.

Religious Considerations

10. **Islamic banking is inherently religion-based, and as a result, is shaped by religious realities that conventional banks may not face.** In particular, Islamic banks are subject to *Sharī`ah* principles, the strict adherence to which is required to preserve the sanctity and validity of Islamic financial transactions. This introduces certain complexities (exacerbated by possible different interpretations of *Sharī`ah* principles), given that, matters related to governance, assets, liabilities, and operations of Islamic banks may have important religious considerations, which generally, do not arise in the case of conventional banks.

11. **Jurisdictions mostly apply international bank supervisory standards to Islamic banks, although sometimes with adjustments.** While jurisdictions apply the Basel Core Principles on Bank Supervision to Islamic banks, these are often subject to *Sharī`ah*-specific adjustments, that have implications for the computation of capital adequacy ratios (“CAR”), liquidity management practices, corporate governance, accounting treatment, determination of rights and responsibilities of the contracting parties.⁶ The lack of consistency in the application of prudential norms across Islamic jurisdictions, has implications for supervision and, in particular, cross-border and consolidated supervision. While the IFSB and the Accounting and Auditing Organization for Islamic Financial Institutions (“AAOIFI”) are helping to harmonize prudential standards (IFSB),⁷ and accounting, audit, and governance practices (AAOIFI), these are still not uniformly applied across countries.⁸

⁶ See Inwon Song and Carel Oosthuizen, “Islamic Banking Regulation and Supervision: Survey Results and Challenges” *IMF Working Paper 2014* WP/14/220. The IFSB is an international standard-setting organization that promotes the soundness and stability of the Islamic financial services sector through the issuance of non-binding prudential standards and related guidance principles. Also see “Core Principles of Islamic Finance Regulation (Banking Segment)” IFSB–17, April 2015.

⁷ In addition to prudential standards, the IFSB issues guiding principles as well as technical and guidance notes

⁸ See “Islamic Finance: Opportunities, Challenges, and Policy Options” IMF Staff Discussion Note, April 2015; and Song, In Won and Carel Oosthuizen, “Islamic Banking Regulation and Supervision—Survey Results and Challenges,” IMF Working Paper No. 14/220 (Washington: International Monetary Fund, 2014).

12. **The extent to which *Sharī`ah* law may affect supervisory standards, differs among jurisdictions.**⁹ There are jurisdictions where *Sharī`ah* is incorporated into the secular law, and where the supervisory authorities have a responsibility to ensure compliance with *Sharī`ah* principles. In others whose legal systems are not fundamentally based on *Sharī`ah*, the bank supervisory authorities typically do not take a *Sharī`ah* perspective, and tend not to build any capacity or capabilities that will enable them to make any determination relating to *Sharī`ah* compliance.¹⁰ In yet another category of jurisdictions—including the U.K., for example—the bank regulatory framework does not contain any separate prescriptions on Islamic banking or *Sharī`ah* compliance,¹¹ although the relevant authorities may take that into account indirectly, when considering issues such as governance, internal controls, reputational risk, and consumer protection.¹²

13. **There is a fundamental question as to the role of *Sharī`ah* compliance in the resolution of Islamic banks.** Among other things, should the legal powers, tools, and techniques by which resolution is effected and implemented, be *Sharī`ah* compliant? If so, what institutional arrangements for resolution are required, and what legal powers, tools, and processes are applicable? As a general matter, given that the sanctity and validity of Islamic finance hinges on the *Shari`ah*, it would appear that a resolution regime for Islamic banks may have to be *Shari-ah* compliant. From a practical standpoint also, a *Sharī`ah* non-compliant resolution regime could raise concerns for investors and other providers of funds, which could have implications for stability of the financial sector. For this reason, it is important to consider the possible application of *Sharī`ah* bankruptcy principles (*iflās*), as well as *Sharī`ah*-based market regulation (*hisba*) in the design of Islamic bank resolution regimes.¹³ For example, mandatory forgiveness of debt appears to be forbidden under *Sharī`ah* law, given that Islamic debtors are expected to pay their debts. Consequently, there is no final discharge of indebtedness under *Sharī`ah* principles in the context of a bankruptcy, as the debtor remains obligated to pay its debts until payment in full or voluntary debt forgiveness by the creditor. Furthermore, unsecured creditors share *pro rata* in the

⁹ Inwon Song and Carel Oosthuizen, “Islamic Banking Regulation and Supervision: Survey Results and Challenges” *IMF Working Paper 2014 WP/14/220*.

¹⁰ Awad Abed and Robert E. Michael explain the complexities of the *Sharī`ah* as a source of law versus as the primary source of law in various jurisdictions. See Abed Awad & Robert E. Michael, *Iflas and Chapter 11: Classical Islamic Law and Modern Bankruptcy*, 44 *Int’l Law*. 975 (2010), available at <http://digitalcommons.pace.edu/lawfaculty/749/>.

¹¹ Such as requirements for *Sharī`ah* boards.

¹² Inwon Song and Carel Oosthuizen, “Islamic Banking Regulation and Supervision: Survey Results and Challenges” *IMF Working Paper 2014 WP/14/220*.

¹³ Although there appears to be no congruence in the applicability of conventional insolvency practices in the Islamic context. See McMillen, Michael J. T., “An Introduction to Shari'ah Considerations in Bankruptcy and Insolvency Contexts and Islamic Finance's First Bankruptcy (East Cameron)” (June 17, 2012).

unencumbered assets of the debtor.¹⁴ The possible implications of these principles for resolution are addressed later in this paper.

Governance

14. **Islamic banks are typically mandated to have in place an appropriate governance function and internal control system to ensure *Sharī`ah* compliance.**¹⁵ In most jurisdictions, the function and role of ensuring *Sharī`ah* compliance within an Islamic bank is the responsibility of a *Sharī`ah* board, which oversees and is assisted by internal auditors, *Sharī`ah* auditors, or external auditors (although the latter appear to be in the minority), and by *Sharī`ah* review, control and research functions.¹⁶ A majority of jurisdictions therefore require Islamic banks, unlike conventional banks, to have a *Sharī`ah* board. Some jurisdictions (e.g., Kenya and Tunisia,), however, do not require Islamic banks to have *Sharī`ah* boards.

15. ***Sharī`ah* boards are comprised of a specified number of *Sharī`ah* scholars and sometimes specialists such as economists, accountants, financial sector experts, and lawyers.**¹⁷ Their main function is to review and ensure that all transactions, contracts, products and activities relating to the Islamic bank, comply with *Sharī`ah* law and principles.¹⁸ *Sharī`ah* boards can issue *fatawa* and rulings that are binding on Islamic financial institutions. Generally, *Sharī`ah* boards review transactions *ex-ante*, and approve them from a *Sharī`ah* perspective, although in some cases, this may be done on an *ex-post* basis. It is important to mention that *Sharī`ah* boards are also responsible for the entire *Sharī`ah* governance regime within the financial institution, even though there is usually a mechanism that allows direct access to the board of directors if there is some type of failure (or alleged failure) within this *Sharī`ah* governance regime.

16. **Different types of *Sharī`ah* board models exist in various jurisdictions.** There are essentially two main models of *Sharī`ah* boards. Some jurisdictions have centralized

¹⁴ *Id*

¹⁵ *Id*. The IFSB and AAOIFI recommend the establishment, of an independent *Sharī`ah* Supervisory Board (SSB) at the bank level, a well-resourced internal *Sharī`ah* review process, and periodic external *Sharī`ah* reviews.

¹⁶ Song, Inwon and Carel Oosthuizen, “Islamic Banking Regulation and Supervision—Survey Results and Challenges,” IMF Working Paper No. 14/220 (Washington: International Monetary Fund, 2014).

¹⁷ The *Sharī`ah* board reports sometimes to the board of directors, to shareholders, or to senior management of an Islamic bank, although IFSB and AAOIFI standards require reporting to the board of directors: AAOIFI recommends, in its relevant standard, that the *Shari`ah* board be comprised of not less than three members. Increasingly, secular legislation specifies the number of scholars on the *Shari`ah* board. AAOIFI also has recommendations on the operation of the *Shari`ah* board and the *fatawa* that are issued by the *Shari`ah* board.

¹⁸ Pursuant to the AAOIFI Governance Standards on *Shari`ah* Supervision and Compliance, *Shari`ah* boards are entrusted with the duty of directing, reviewing and supervising the activities of the Islamic financial institutions in order to ensure that they are in compliance with Islamic *Shari`ah* rules and principles.

Sharī`ah boards, in some cases within the Central Bank, which issue binding rulings for all Islamic banks.¹⁹ Many other countries²⁰ adopt a decentralized approach where individual *Sharī`ah* boards exist within each Islamic bank, with power to issue decisions that are only binding on the institution in which they are housed. The two models are not always incompatible, as there are countries with a centralized *Sharī`ah* board that also require individual Islamic banks to have their own *Sharī`ah* boards. In such jurisdictions, the *Sharī`ah* board within the bank issues rulings that are binding on the bank, subject to the rulings issued by the centralized *Sharī`ah* board. The model used by a particular country may have implications for institutional arrangements for resolution of Islamic banks (see part III of this paper).

Balance Sheet Considerations

17. **The design of a resolution regime for Islamic banks would need to take into account the distinct features of their balance sheets.** Assets and liabilities of Islamic banks tend to differ from those of conventional banks. Islamic banking relies on a diverse spectrum of *Sharī`ah* -compliant contracts in financial transactions that provide for different risk and return profiles.²¹ Table 1 depicts some stylized features of Islamic banks' balance sheets.

¹⁹ Examples are centralized *Shari'ah* boards set up at the central banks of Brunei, Morocco, Nigeria, Sudan, and the United Arab Emirates (U.A.E.) In countries like Malaysia, and Pakistan, both the Central Bank and Securities Commission each have their respective *Shari'ah* boards. In Indonesia and Kuwait, bank supervisory agencies have access to the Council of Scholars established by their respective Ministries of Religious Affairs.

²⁰ For example: Turkey, Jordan, Qatar, and Lebanon.

²¹ Some transactions entail a complex tri-partite bundle of rights *in rem* and *in personam* between the investor, the bank and the investee in order to comply with *Sharī`ah* principles, such as the prohibitions of interest (*riba*-profit making without real economic activity), gambling (*maisir*) and uncertainty (*gharar*).

Table 1: Stylized Balance Sheet of Islamic and Conventional Banks

Balance Sheet of an Islamic Financial Institution	Balance Sheet of a Conventional Financial Institution
Assets	Assets
Cash and cash equivalents Investment in securities Sales Receivables Investments in leased assets Investments in real estate Equity/Profit-sharing financing Investment in Subsidiaries Fixed assets	Cash and cash equivalents Investment in securities Loans and advances Statutory deposits Investment in Subsidiaries Fixed assets Other assets
Liabilities	Liabilities
Current Accounts Other Liabilities	Current Accounts Saving and Time Deposits Other Liabilities
Equity of PSIA	
PSIA (Unrestricted) Profit Equalization Reserve, Investment Risk Reserve	
Owner's Equity	Owner's Equity
PSIA (Restricted) [Off-balance sheet] [Letters of Credit, Guarantees]	Off-balance Sheet [Letters of Credit, Guarantees, Derivatives]

Source: "Islamic Finance: Opportunities, Challenges, and Policy Options" IMF Staff Discussion Note, April 2015

Note: PSIA=profit-sharing investment account.

Note: Differences are shown in red.

18. **Islamic banks' asset portfolios reflect a mix of complex structures.** These include contracts that are economically equivalent to pure lending transactions (e.g., vector *muḍārabah* transactions involving platinum or palm oil), as well as equity-like and partnership financing contracts (e.g., *mushārahah*), lease-based financing contracts (e.g. *ijarah*), fee-based activities (e.g., *wakalah*), and non-remunerated lending contracts (e.g., *qard and wadiah*). Others are structured as sales with mark-up and deferred payments (*Murābahah*), and purchases with deferred delivery of products (*salam* for basic products and *istisna 'a* for manufactured or constructed products).

19. **On the liabilities side, a number of variations exist as well, although many of these liabilities are not deposits in the traditional sense, such as those typically held by conventional banks.** Examples include guaranteed *Sharī`ah* safekeeping (“deposit”) contracts (*qard or wadi`ah*), as well as non-guaranteed *Sharī`ah* contracts for investment (*muḍārabah and wakalah*), profit sharing investment accounts (restricted and unrestricted), and *sukūk*. In particular:

- ***Current accounts:*** Current accounts in Islamic banks are similar to traditional deposits, although they tend to be non-interest/return bearing. Islamic banks sometimes provide these accounts with a “gift” (*hiba*) equal to the amount of interest that is provided by competitor conventional banks on equivalent accounts. This gift amount is financed from the Islamic bank’s capital. From an accounting and legal perspective, current accounts tend to be treated in a manner similar to traditional current deposit accounts.
- ***Profit-Sharing Investment Accounts (“PSIAs”):*** Investment accounts held with Islamic banks are unlike deposits. They are structured as partnership (*muḍārabah*,²² or *mushārahah*),²³ or agency (*wakala*) contracts., In each of the partnership arrangements, profits generated from financing and investment activities are shared by the bank and investment account holders, based on a predetermined profit-sharing ratio. These profits function as an expected, rather than a guaranteed, return. Legally, the bank does not guarantee the principal amounts or returns to the account holder, and these accounts may not enjoy the legal protections that depositors of conventional banks typically enjoy. In many cases, they are not treated as liabilities of the Islamic bank. They may more commonly be treated as assets of the investment account holder, who provides most, if not all, of the funds. To the extent that the Islamic bank may be entitled to a share of the profits from the investments made by these accounts, it may treat its share as an asset. The two main types of PSIAs are:
 - (i) ***Unrestricted investment accounts:*** In the case of unrestricted investment accounts on the other hand, the account holder grants the bank full discretion to invest in any *Sharī`ah* -compliant asset. These are the most common PSIAs. Assets in which the bank invests the account holder’s funds, may be comingled with assets held on behalf of other account holders, or the bank’s own assets, making them difficult to attribute to specific account holders.

²² Under the *muḍārabah* contract, profits generated by the investment are shared between the providers of capital (*rabbu mal*) and the bank (*mudarib*) as the provider of “work” (investment management activities) in accordance with the ratio specified in the contract. Losses from the capital invested are typically borne solely by the capital provider (except in the case of fraud, misconduct, negligence, or breach of contracted terms and conditions by the bank). The bank is however exposed to the loss of its time and effort.

²³ Under the *musharaka* contract, profits generated by the investment of capital are shared in accordance with the terms of the *mushārahah* contract, while losses are shared in proportion to each partner’s share of capital.

However, the bank should be able to determine the relative shares of all partners (including the bank's shareholders) that financed a particular asset.

- (ii) *Restricted investments accounts*: The key feature of these accounts is that the bank's mandate is restricted to investing the account holder's capital in specific assets agreed with the account holder, sometimes through a special purpose vehicle ("SPV"). These underlying assets are usually not commingled with the banks' own assets and as a result, may be relatively easy to trace and to transfer or sell in favor of account holders if need be, in the context of resolution of the bank. The funds of different customers with similar restricted investment accounts, however, tend to be pooled and commingled as they are considered partners in financing as a whole. It therefore may not always be possible to trace assets to a particular customer, although losses will likely be absorbed according to the respective percentage contributions to the pool of assets.
- ***Profit Equalization Reserves and Investment Risk Reserves***: Profit equalization reserves ("PERs") and Investment Risk Reserves (IRRs) are unique features of Islamic banking. IRRs are created by setting aside amounts out of the profits attributable to investment account holders (after deducting the Islamic bank's *mudārib* share of those profits), in order to cushion the effects of future investment losses on account holders. As a general matter, Islamic banks do not have a share in IRRs. PERs, on the other hand, represent liabilities that are collectively owed to investment account holders and the bank, in proportion to their respective profit and loss shares in the investment. PERs are generally accumulated from general profits of the bank, to help enhance the profit payout of investment account holders in periods when the asset pools funded by account holders have experienced losses, and also to help enhance dividend payouts to shareholders.²⁴ The portion of these reserves that are attributable to investment account holders, are typically invested in assets that produce returns for all such investment accounts holders (on a pooled basis), as well as the bank if so provided by the investment account agreement. In the context of resolution, a key legal issue would be how to define clearly the rights of account holders versus those of the bank, to PERs. The potential shares of various account

²⁴ While Islamic banks typically share profits and losses with providers of capital and therefore do not strictly-speaking guarantee returns, they tend to pay returns to providers of capital due to competition from conventional banks. Islamic banks therefore may face the so-called displaced commercial risk, whereby they are forced to pay returns because investors expect them to, even if the underlying assets do not earn profits. Islamic banks therefore employ "smoothing" techniques to be able to pay out returns to investors in periods when the returns from the underlying assets are below the returns that competing conventional banks are paying their customers. For a more detailed exposé on profit equalization reserves and other profit payout "smoothing" mechanisms, see "Guidance Note on the Practice of Smoothing the Profits Payout to Investment Account Holders", IFSB 2010.

holders to the PERs, depend to a large extent on contractual arrangements. Owing to the lack of legal clarity in some jurisdictions, however, supervisory authorities or courts could decide that the outstanding balance of PERs should be distributed differently from what was initially agreed between the parties.²⁵

- ***Sukūk***: *Sukūk* are usually described as the Islamic equivalent of conventional bonds. More accurately, they are certificates of participation or trust certificates issued directly by an Islamic bank or by an SPV set up by the bank. In addition, banks frequently invest in *sukūk* issued by third parties. While there are different *sukūk* structures,²⁶ most *sukūk* are structured with one or more underlying assets transferred to an SPV by the originating bank, in exchange for the proceeds of the *sukūk* issuance by the SPV. For example, under the *sukūk ijarah* model which appears to be popular, *sukūk* holders receive certificates that represent some level of interest in the underlying assets. Rent or other payments from the segregated assets are then paid out to the SPV, which in turn pays such amounts to the *sukūk* holders periodically in line with the terms of issuance. At the maturity of the *sukūk*, the amount raised from the *sukūk* issuance is repaid by the SPV to *sukūk* holders, after disposal of the assets. The legal treatment may depend on whether the *sukūk* transaction involves a true sale or otherwise, of the underlying assets. In an **asset-backed** *sukūk* transaction, assets are transferred by the originating bank to an SPV by way of a true sale. Legal title to the assets passes to the SPV, as a result of which general creditors of the originating bank have no claim on these assets. Holders of *sukūk* issued by the SPV will have claims against the SPV but not against the originating bank, except to the extent that the transferred assets are not as represented and warranted by the bank. Where the **asset-based** model is used, no true sale of the bank's assets occurs,²⁷ and the originating bank retains legal ownership of the assets managed by the SPV and underlying the *sukūk* issuance. In the event of default by the SPV *under an asset-based model*, *sukūk* holders may have a residual unsecured claim against the bank for any shortfall upon realization of the assets held by the SPV.

20. **The treatment of Islamic banking products for prudential regulatory requirements and for deposit insurance purposes is worth mentioning.** In particular, the IFSB's capital adequacy standards do not classify PSIA as part of an Islamic bank's capital because they do not meet the criteria of "Core" or "Additional Capital." Furthermore, IRRs and PERs belong to investment account holders and thus are not part of the capital of the

²⁵ See section 4.3 "Issues Arising on Liquidation" in IFSB GN-3 "Guidance Note on the Practice of Smoothing the Profits Payout to Investment Account Holders", December 2010.

²⁶ There are 14 permissible categories of *sukūk* under the relevant AAOIFI standard (number 17). Five of those categories are *ijarah* based. Other common *sukūk* structures are the *murabahah*, *wakalah*, *musharakah* and *istisna* contracts.

²⁷ The SPV in such cases is only granted rights to manage the assets made available to the SPV by the bank.

Islamic bank, except to the extent that the bank may have a share in PERs by virtue of contractual stipulations. Given that the purpose of the PER is to smooth the profit payouts and not to cover losses, any portion of the PER that is part of the Islamic bank's reserves should not be treated as part of its regulatory capital.²⁸ Furthermore, classification of Islamic banking contracts for purposes of determining insurability for deposit insurance schemes is problematic. There appears to be more consensus regarding the possible insurability of *wadiah* or *qard* contracts, while jurisdictions appear divided on the definition and treatment of PSIA. Some jurisdictions however provide protection to both unrestricted and restricted PSIA holders, while others only provide protection to unrestricted PSIA holders. There are some jurisdictions that do not provide any protection to PSIA holders.²⁹

III. INSTITUTIONAL ISSUES IN RESOLUTION OF ISLAMIC BANKS: THE RESOLUTION AUTHORITY AND SHARĪ AH BOARDS

21. **International standards for the design of the resolution authority may be broadly appropriate for both conventional and Islamic banking systems.** The KAs (KA 2) require jurisdictions to designate and empower a resolution authority with a sufficiently broad mandate, operational independence, a robust governance structure and adequate resources. There appears to be no reason why the designation of a resolution authority for an Islamic banking system should depart from these principles. It is also important to ensure that the resolution authority has sufficient expertise, knowledge and human capacity to implement resolution measures. This is even more critical in the context of Islamic banking, due to the *sui generis* nature of their operations.

22. **In dual banking systems, the question arises as to which agency is best suited to act as resolution authority for Islamic banks.** In principle, it is possible either to designate the same resolution authority for both conventional and Islamic banks, or to designate a separate agency for each. The latter alternative could be difficult to implement, with attendant coordination and cooperation challenges, particularly for banking groups comprised of conventional and Islamic banks. The choice will depend, among other things, on the relative size of the conventional and Islamic banking systems, as well as on the availability of the necessary expertise to engage in bank resolution. A separate Islamic resolution authority to address the particularities of Islamic operations may be preferable in

²⁸ See paragraph 2.1.2 on Treatment of PSIA, PER and IRR : Revised Capital Adequacy Standard for Institutions Offering Islamic Financial Services excluding Islamic Insurance (Takaful) Institutions and Islamic Collective Investment Schemes, IFSB 15, December 2013.

²⁹ The IFSB has not yet adopted a standard or guideline on *Sharī`ah*-compliant deposit insurance, and the Islamic Deposit Insurance Group of the International Association of Deposit Insurers has concluded that *Sharī`ah* compliance is a key challenge for an Islamic Deposit Insurance Scheme. See "Islamic Finance: Opportunities, Challenges, and Policy Options" IMF Staff Discussion Note, April 2015. The IFSB has produced a draft working paper on *Sharī`ah*-compliant deposit insurance schemes, which was recently approved by the IFSB Technical Committee for members' comments.

countries with a large Islamic banking system. From a practical standpoint, however, and given that Islamic banks in several jurisdictions are supervised by the same agencies that supervise conventional banks, there is a strong argument for a single resolution authority for both Islamic and conventional banks. Whatever the approach adopted by a jurisdiction, it will be important to ensure that the resolution authority has a clear mandate, as well as a thorough understanding of Islamic finance operations. Moreover, where a jurisdiction establishes separate resolution authorities for conventional and Islamic banks, it will be important to put in place effective mechanisms for coordination and cooperation between the two agencies, and to designate which of the two authorities would lead the resolution process.

23. In designing a *Sharī`ah*-compliant regime for resolution, it is important to ensure that institutional arrangements promote orderly resolution. In particular, if it is deemed necessary that the resolution process and measures be *Sharī`ah* compliant,³⁰ the institutional arrangements for certifying such compliance should not undermine the mandate and autonomy of the resolution authority, and should not impede prompt and orderly resolution. In this regard, the role of *Sharī`ah* boards (if any) in ensuring that resolution complies with relevant *Sharī`ah* principles, should be carefully considered. While it may seem reasonable to assume a role for the *Sharī`ah* board of an acquiring Islamic bank, any potential role of the *Sharī`ah* board of a bank in resolution would have to be justified. In any event, it needs to be considered, whether the usual power of resolution authorities to suspend or remove boards of directors of banks in resolution, would be appropriate in the Islamic bank context as it relates to *Sharī`ah* boards. Where *Sharī`ah* boards are involved in certifying *Sharī`ah* compliance of resolution measures, the legal framework ought to provide for a mechanism for dealing with potential conflicts that could emerge between a *Sharī`ah* board and the resolution authority, or between two or more *Sharī`ah* boards.³¹ In jurisdictions that have a centralized or national *Sharī`ah* board, this risk would seem to be mitigated. In those that do not have centralized or national *Sharī`ah* boards, consideration may be given to empowering the resolution authority to establish its own *Sharī`ah* board to advise it on resolution measures.

IV. RESOLUTION POWERS

24. A key feature of any bank resolution framework is the range of resolution powers available to the resolution authority. To be effective, the resolution framework

³⁰ This may be seen by some *Sharī`ah* scholars and the industry as pragmatic, even if not strictly required, if the resolution authority is to have any legitimacy.

³¹ This may be the case where *Sharī`ah* boards of the bank under resolution and a prospective acquiring bank reach conflicting conclusions about the compliance of a proposed resolution measure with *Sharī`ah* principles. It is important to note that the likelihood of different interpretations will be higher in case of cross-border operating banks, and that such differences will be more complex to resolve.

should explicitly empower the resolution authority to assume effective control of a bank and to take appropriate restructuring measures. Where feasible, the resolution authority should have a variety of restructuring powers and tools to stabilize and restructure an institution.

25. Triggers for activating resolution powers in respect of Islamic banks, should reflect their unique business model. A good legal framework for resolution should provide for clear triggers (such as quantitative and/or qualitative triggers) for placing a bank in resolution. For conventional banks, quantitative triggers largely reflect a “borrowing and lending” business model, with indicators of non-viability that include weak regulatory capital adequacy ratios (CAR), and persistent liquidity problems (e.g., inability to pay debts as they fall due).³² In the case of Islamic banks, the application of conventional resolution triggers may be problematic, given differences in their business model which relies heavily on sales, leasing, and profit/loss arrangements.³³ Challenges in the computation of CAR as a result of balance sheet complexities would need to be addressed to promote transparency in resolution and to minimize legal risks for the resolution authority.³⁴ Also, profit and loss arrangements under *muḍārabah* and *mushārah* contracts, lease-based or sale/purchase type arrangements, could require unconventional triggers to determine the likelihood of non-viability of a bank, on a timely basis.

26. At the same time, such triggers should meet the high threshold required in the case of conventional banks. Generally, triggers for resolution require a high threshold—namely, that of non-viability or likely non-viability or continuing practices that endanger deposits or other financial contracts, as well as stability of the financial sector. While possible triggers for Islamic bank resolution could be designed to reflect their unique contractual arrangements, they should not be set so low as to include a simple contractual default, unless it reflects more underlying institutional problems that threaten viability of the bank or otherwise endangers financial stability. Triggers such as non-payment or delayed payment of rents or profits, or misuse of underlying assets contrary to the terms of agreement or in a manner prejudicial to the interests of the clients or account holders,

³² Qualitative triggers on the other hand, include persistent or severe violation of prudential and other regulatory requirements, or the conduct of the business of a bank in a manner detrimental to its depositors, and the financial system as a whole.

³³ Also in the traditional *Sharī`ah* context, bankruptcy proceedings are ripe when a debtor is (i) balance sheet insolvent (where its liabilities exceed its assets); or (ii) income statement/cash flow insolvent (where it has insufficient liquid assets to pay debts on time). These may not be appropriate triggers for resolution, where triggers should reflect non-viability (or likelihood thereof) or business conduct that is prejudicial to financial instability.

³⁴ For a detailed discussion on supervisory challenges for Islamic banks including in the computation of CAR given certain instruments like the profit sharing investment accounts, see Islamic Finance: Opportunities, Challenges, and Policy Option, IMF Staff Discussion Note, April 2015 page 20.

among others, could therefore be explored. Also, resolution triggers may need to protect the interests of claimants who are not depositors, but who are counterparts of the bank under Islamic finance contracts. In the case of Malaysia (Box 1), the legal framework empowers the resolution authority to trigger resolution in circumstances which detrimentally affect an Islamic bank’s “depositors, investment account holders, participants, users, creditors or the public generally.”

Box 1: Resolution Triggers Under Malaysia’s Islamic Financial Services Act of 2013 (section 177)

- The institution has breached or contravened any provision of this Act, the Central Bank of Malaysia Act 2009 or any written law, regardless that there has been no prosecution or other action in respect of the breach or contravention;
- The institution has failed to comply with any direction under section 168;
- The assets of the institution are not sufficient to give adequate protection to its depositors, investment account holders, *takaful*¹ participants, participants, users or creditors, as the case may be;
- The capital of the institution has reached a level or is eroding in a manner that may detrimentally affect its depositors, investment account holders, *takaful* participants, participants, users, creditors or the public generally;
- The institution has become or is likely to become insolvent or unable to meet all or any of its obligations; or
- Any other state of affairs exists in respect of the institution that may be materially prejudicial to the interests of the depositors, investment account holders, *takaful* participants, participants, users or creditors of the institution or the owners of any assets under the licensed person’s administration, including where proceedings under a law relating to bankruptcy or insolvency have been commenced in Malaysia or elsewhere in respect of the holding company of the institution, including its financial holding company.

¹ These are *Shari`ah* compliant mutual insurance schemes.

27. Furthermore, the legal framework for resolution of Islamic banks should provide explicitly for a broad range of powers to facilitate effective resolution. The KAs recommend among other things, powers: (i) to replace senior management; (ii) to take official control and place a bank under official administration; (iii) to impose moratoriums and stays if necessary; and (iv) to restructure the bank. Powers to take official control, replace management, and impose moratoriums and stays, are typically employed at the

onset of resolution if needed, to support the effective deployment of restructuring powers and techniques.

28. **In the application of resolution powers in an Islamic bank context, the legal framework should make financial stability a key objective.** The exercise of some resolution powers may be perceived as infringing on the individual property rights of an Islamic bank’s claimants (such as shareholders and creditors). There is however the need to clarify the circumstances under which the financial stability objective may override such individual rights. Generally, it would appear that *Sharī`ah* principles of (i) protecting the public good (*maslahah*); and (ii) necessity (*al darourat toubih al mahzourat*), would be relevant in this regard. Whether these principles would justify an override of shareholder rights in resolution, is a matter that should be explored. In any event, clarity is required as to how resolution powers may be crafted in order to meet the “public good” and “necessity” tests under *Sharī`ah* law.

A. Taking Control and Supporting Resolution of Islamic Banks

Replacement of Management

29. **In resolving an Islamic bank, the resolution authority should have power to replace senior management of the bank.** Typically, the legal framework for problem banks should enable authorities to take increasingly stringent measures, as needed. It should empower the supervisory authorities to instruct bank management to implement actions to strengthen a bank or to refrain from actions that would further weaken the bank’s financial position; where a bank’s management does not comply with these measures, the supervisory authorities should be empowered to replace management swiftly. In the context of resolution, the KAs provide for the power of the resolution authority to replace management of the bank in order to facilitate orderly resolution. There appears to be no difficulty in exercising such a power in an Islamic banking context. However, this should be explicit in the legal framework.

Official Administration

30. **Similarly, an Islamic bank resolution framework should empower the authorities to place an ailing Islamic bank under official administration, under appropriate circumstances.** The resolution authority should be empowered to appoint an “official administrator” who would take control of and manage a failed bank, ideally to restore it to viability under the strategic guidance of the resolution authority. The official administrator typically assumes the legal powers of the failed bank’s board of directors, managers, and shareholders and displaces their authority. The power to impose official administration appears unlikely to pose any difficulties in an Islamic banking context. For example, Malaysia’s Islamic Financial Services Act of 2013 explicitly provides to the

Central Bank of Malaysia as resolution authority, the power to assume control of an Islamic bank and to manage the whole or part of the business and affairs of such bank.³⁵

31. A number of prerequisites would however be useful, where official administration of an Islamic bank is concerned.

- The legal framework should clarify the scope of the mandate of the official administrator. In particular, the official administrator's role in reviewing the institution's financial situation, and designing and implementing its rehabilitation plan would likely need to be in compliance with relevant *Shari'ah* principles. Again, clarity would be required in the legal framework as to whose interpretation of *Shari'ah* principles should be applied by the official administrator.
- Secondly, the legal framework should clarify the extent to which official administration would displace the *Shari'ah* board of a bank in resolution. In jurisdictions that do not empower the resolution authority itself to decide on the *Shari'ah* compliance component of resolution measures, the legal framework would need to clarify whether the *Shari'ah* board of the bank in resolution continues to have a role in official administration, and the precise nature of that role. At a minimum, it would seem reasonable for the legal framework to provide for the power to remove *Shari'ah* board members who no longer meet "fit and proper" requirements.³⁶ In the case of resolution, however, the legal framework should more explicitly clarify whether placing an Islamic bank under official administration automatically displaces the *Shari'ah* board. In addition, it may be necessary to replace much of the *Shari'ah* governance structure (audit, review, research, etc), and the legal framework should clarify how this would be addressed.
- Third, official administrators of Islamic banks should have the necessary expertise to evaluate and engage in complex Islamic banking operations. An official administrator of an Islamic bank would require sufficient expertise in the area of Islamic finance, to be able to design and implement an optimal resolution strategy for the bank. The legal framework for resolution should therefore require appropriate qualifications and

³⁵ (Act 759), section 179. The power to assume official control of an Islamic bank in Malaysia is however subject to prior approval of the Minister of Finance.

³⁶ The supervisory authorities should have the power: (i) specify *ex-ante* the criteria for the appointment and replacement of *Shari'ah* scholars; (ii) to require prior notification of the appointment of a *Shari'ah* scholar to a bank's *Shari'ah* board; and (iii) to vet them formally on their propriety. Also, IFSB-10 (Guiding Principles on *Shari'ah* Governance Systems for IIFS) empowers a bank's board of directors to remove members of the *Shari'ah* board for non-performance after a formal assessment of their performance as a whole and their respective contributions to overall effectiveness within the bank in question. This power, currently reserved for the board of directors, could be conferred also on the resolution authority, without the requirement of a formal assessment to determine effectiveness.

experience for official administrators of Islamic banks. In jurisdictions where finding individuals with the requisite knowledge and expertise would be a challenge, the legal framework could require the official administrator to have customary qualifications from a resolution perspective, and the power and authority to retain people with *Shari`ah* and Islamic banking expertise.

Moratoriums and Stays

32. **The legal framework for resolution of Islamic banks should provide for the power to impose moratoriums and temporary stays on transactions of a bank in resolution, if needed.** The KAs contemplate that the use of such powers may be necessary in some cases, to facilitate orderly resolution, with minimal impact on financial stability. Imposing a moratorium on payments or a temporary stay on creditor actions would not appear to raise difficulties in the case of Islamic banks. The objective of a moratorium and a stay on enforcement actions is to avoid the dissipation of value and ensure the equal treatment of all creditors in liquidation.

B. Restructuring of Islamic Banks in Resolution

33. **The Key Attributes set out resolution powers and tools for allocating losses to private creditors and shareholders.** These include the powers (i) to merge ailing banks with stronger institutions; (ii) to undertake a Purchase and Assumption (“P&A”) transaction by transferring assets and liabilities to a healthy institution or a so-called “bridge bank”; (iii) to mandatorily restructure (“bail-in”) debt, equity, and other claims of a financial institution, by writing down its unsecured debt and/or converting it into equity; or (iv) to eliminate or dilute existing shareholders’ claims while the relevant institution remains open. Among other things, these powers should be exercised without the need to obtain the consent of existing shareholders or creditors, subject to appropriate safeguards such as the “no creditor worse-off” principle. Above all, clarity in the legal framework is required to ensure that the resolution authority is able to exercise these powers promptly and with legal certainty.

34. **As mentioned earlier in this paper, Islamic banks’ balance sheets reflect a complex mix of *Shari`ah* contracts, requiring careful analysis of the restructuring tools applicable.** In particular, the extent to which the KAs’ restructuring powers may be applied to Islamic banks in resolution would require an analysis in the context of their balance sheets, and creditor hierarchies.

Creditor Hierarchy

35. **Creditor hierarchies determine the ranking or order in which losses will be allocated against the claims of various stakeholders, in the liquidation or restructuring of a bank in resolution.** Typically, losses are first allocated to shareholders, before subordinated debt holders and other unsecured creditors in ascending order, with

depositors (at least some, such as small or insured deposits) being the last to be hit with losses. Depositor preference gives depositors a preferential claim on the assets of a failed bank, and can mitigate the likelihood of contagion by providing depositors with a higher probability of recovering their claims in a bank failure.

36. The creditor hierarchy of Islamic banks would need to be carefully designed, given their unique liability structure and the need to avoid financial stability risks. Claims would have to be clearly classified in order to determine how they are ranked for loss allocation. While it would seem reasonable to argue that current account holders are depositors and that their claims should enjoy depositor preference if provided for, other Islamic banking products (such as investment accounts) may not be that clearly defined for this purpose. For example, as discussed in part II of this paper, investment accounts are generally not structured as conventional deposits, and Islamic banks typically have no liability towards investment account holders, except to the extent of allocating profits or losses from their investments. There are however jurisdictions that treat unrestricted investment accounts holders as “depositors” for purposes of deposit insurance,³⁷ given their potential financial stability implications. In other jurisdictions, investment account holders are treated as equity holders in the assets in which their capital is investment by the bank (similar to shares in a mutual fund). For instance in Malaysia, these accounts are treated for supervisory and resolution purposes as a separately allocated group of investments, from which the account holders and the Islamic bank gets profit (and loss) shares, in accordance with contractual arrangements.³⁸

37. Preferential treatment of one class of claims over others in the case of Islamic banks, should be carefully approached. Typically, the resolution authority for any bank is required to observe the *pari passu* principle, by which all claims of the same class are to be treated equally. The KAs however allow flexibility to depart from *pari passu* treatment if necessary to contain the systemic impact of a firm’s failure or to maximize value for all creditors,³⁹ provided that the legal framework promotes transparency in this regard. From a *Shari`ah* perspective, unequal treatment of creditors appears prohibited, in the absence of *a priori* agreement by the parties. This principle seems to suggest that all claims of the same class against an Islamic bank should be treated equally in resolution. In resolving a bank with inadequate assets to cover all liabilities, this could pose challenges for orderly

³⁷ For example, Malaysia and Turkey.

³⁸ In the case of Malaysia, the Islamic Financial Services Act provides for the preferential treatment of Islamic deposits. Moreover, in the case of investment accounts, the said law states that the assets of the investment accounts managed by an Islamic bank in Malaysia, will be available in the order set out as follows: (i) to pay outstanding costs or expenses of the investment accounts; (ii) to pay any profit, fees, gains or other remuneration due to the Islamic bank; and (iii) to meet the liabilities to the investment account holders.

³⁹ Key Attribute 5.1.

resolution. This principle may make it even more imperative for the legal framework for resolution of Islamic banks to reflect a creditor hierarchy that distinguishes clearly among liabilities and clarifies statutory powers (if any) to depart from *pari passu* treatment where necessary to help preserve financial stability.

Mandatory Recapitalization and Mergers

38. **There appears to be no difficulty in applying the mandatory recapitalization tool in the resolution of Islamic banks.** In a mandatory recapitalization, the bank is recapitalized through the issuance of new shares to investors who inject fresh capital. Such shares may be issued to existing shareholders, but more typically, will be offered to new investors who dilute the capital position of the existing owners, without the consent of the latter. Furthermore, there may be other relevant *Sharī`ah* principles. For example, the capital structure of an Islamic bank may not have preferred stock or other similar preference arrangements, given their perceived inconsistency (in terms of their fixed-income feature and higher ranking relative to equity), with the *Sharī`ah* principle prohibiting interest (*ribā*).

39. **Similarly, there appears to be no difficulty in pursuing a forced merger of a troubled Islamic bank with a healthier Islamic financial institution, although some issues would need to be addressed.** Conventional bank resolution frameworks typically empower the resolution authorities, having taken control of a troubled financial institution, to merge it with another institution without the consent of the existing shareholders or other stakeholders. There seems to be no reason why such a forced merger could not be exercised in an Islamic banking context where it is necessary to preserve financial stability (see paragraph 28). A forced merger would need to be carried out in a manner that recognizes the specific features of Islamic banks. Among other things:

- The merging institution will need to be a *Sharī`ah* compliant institution or *Sharī`ah* compliant window of a conventional bank. In this context, the purchasing institution may need to acquire a license either for an Islamic window or for a full-fledged Islamic bank. To deal with these cases, the legal framework may need to establish an expedited process for issuing licenses in the context of a resolution process.
- Merger procedures may need to be established to address cases where the acquirer's *Sharī`ah* board is of the opinion that some of the operations undertaken by the acquired bank are not *Sharī`ah* compliant and should be disposed of or liquidated. In some instances, disposing of such operations might cause the purchaser to incur losses and in extreme cases could lead to its failure, thereby threatening the stability of the financial system. In such circumstances, the resolution framework might provide for temporary financial assistance (i.e., a resolution fund) under strict pre-set conditions, such as mechanisms for addressing any *Sharī`ah* non-compliant issue, in a timely fashion.

Purchase and Assumption (P&A) Transactions

40. **While there would appear to be no reason why a resolution authority should not be given the power to transfer the assets and liabilities of an Islamic bank (i.e., through a P&A), hurdles may arise with the practical implementation of this tool.** In a P&A transaction, the resolution authority transfers the assets and liabilities of a troubled Islamic financial institution to a healthy acquirer (or bridge bank) without the consent of existing shareholders or creditors of the troubled bank. In exercising this power with respect to an Islamic bank, a number of challenges will need to be addressed as discussed below and summarized in table 2.

41. **The principal challenge arises from the complex nature of some key assets and liabilities on the balance sheet of an Islamic bank, as described above.** A P&A transaction in an Islamic bank context, may have to be structured quite differently from a P&A of a conventional bank. For example:

- While some claims of an Islamic bank such as current deposits may easily be transferable, more complex claims such as PSIAs and PERs, may be challenging to transfer under a P&A transaction. These claims are typically not treated as liabilities or assets of the Islamic bank, and are primarily investments that belong to the investment account holder, even though the profit participation of the PSIA may be an asset of the Islamic bank.
- In the case of investment accounts, many jurisdictions tend to treat them as client assets and not liabilities of the banks. Jurisdictions would therefore need to clarify the contractual relationship between the bank and the account holder, and in particular, whether the account holder has any recourse to the bank's assets in a resolution.⁴⁰ To the extent investment accounts are treated as client assets, the legal regime should provide for the power of the resolution authority to transfer them to another institution, for the benefit of account holders. The KAs recommend that client assets held by a financial intermediary such as a bank, should be transferred promptly to another intermediary, to promote clients' access to those assets.⁴¹ The KAs advocate for clear and transparent rules on how client assets are defined and treated in the event of failure of the firm that holds the client assets either directly or indirectly (through one or more intermediaries or custodians). In the case of client assets held by a third party custodian, the resolution authority should have the power to transfer the contractual rights

⁴⁰ In the case of unrestricted PSIAs, jurisdictions that treat them as deposits for purposes of deposit insurance coverage, may find it less challenging to include them in a P&A transactions.

⁴¹ Key Attributes Annex 3: Client Asset Protection in Resolution.

and obligations among the custodian, the firm in resolution and its clients, to the qualified transferee.

- The possible treatment of PERs in a P&A transaction is unclear. Such reserves are held on behalf of clients, in order to provide a buffer for payment of their investment returns, although these are usually co-mingled with other liabilities of the Islamic bank. Unless all account holders have previously reached agreement on their respective share of the reserves, they may lose such reserves when transferred, although it is unclear if their claims against the bank in respect of these reserves are thereby extinguished. Perhaps one solution might be for the legal framework to require Islamic banks to clarify in contractual arrangements with clients, how reserves (if any) would be distributed in resolution.
- As in the case of liabilities, a transfer of assets of an Islamic bank could involve some complexities. For conventional banks, principal assets typically transferred under a P&A transaction are performing loans. For Islamic banks, key assets could include sales receivables, participation rights in profit-and loss-sharing arrangements, and leasing receivables. The extent to which these assets could be transferred under a P&A transaction, is unclear, and should be clarified under the legal framework.

42. **More fundamentally, there is little certainty whether a P&A transaction in respect of an Islamic bank would be consistent with *Sharī`ah* principles. In particular:**

- ***Prohibition of sale of debt in return for interest:*** The *Sharī`ah* prohibition against the sale of debt in return for interest (*ribā*), could make P&A transactions for Islamic banks challenging, if at all feasible. Under a P & A transaction, the sale of loan receivables below face value would imply a discount, which could be interpreted as “interest” and therefore possibly barred by the *Sharī`ah*. It may seem reasonable to argue that the objective of loan receivable transfers in a P&A is not to earn interest, but to preserve financial stability in the public interest, although this remains to be clarified authoritatively. Moreover, *Sharī`ah* scholars in some jurisdictions consider that a pure transfer (*hawala*) of debt without an actual sale, may be *Sharī`ah* compliant. Given, however, that *hawala* is a tool for the transfer of debt from a debtor to a third party willing to pay the debt, it is unclear how it may be relied on to transfer receivables of an Islamic bank (as a creditor and not a debtor). It also remains unclear how a transfer of debt could be *Sharī`ah* compliant, given that transferring debt for anything less than face value would constitute embedded interest.
- ***Sharī`ah status of acquiring institution:*** As in the case of a forced merger, it will need to be ensured that the purchaser of a troubled bank’s assets and liabilities is qualified and permitted to undertake Islamic operations. This issue would be particularly pertinent where the acquirer is not itself an Islamic financial institution or a conventional financial institution with an Islamic window. The establishment of a

bridge bank by a resolution authority does not appear to pose concerns from an Islamic banking perspective. Indeed, granting a resolution authority the power to establish bridge institutions to take over critical functions from an ailing bank, may be useful in the case of an Islamic bank. In particular, a bridge bank could also purchase assets and assume liabilities that are considered non-*Sharī`ah* compliant by the *Sharī`ah* board of the transferee bank and sell them once another buyer has been found.

Mandatory Debt Restructuring ('Bail-in')

43. While bail-in powers should be provided for, in respect of Islamic banks, some *Sharī`ah* considerations could pose challenges in their application. Bail-in as contemplated by Key Attribute 3.5, involves the mandatory write-down or conversion of debt, equity, and other capital instruments of a bank in resolution, to help stabilize the bank and to allocate losses among shareholders and unsecured and uninsured creditors. While the concept of loss allocation to claimants does not appear to be foreign to *Sharī`ah*,⁴² the extent to which bail-in powers could be applied in the resolution of an Islamic bank, is unclear. For example:

- **The concept of debt write-down and the “no debt forgiveness” principle.** As discussed earlier in this paper, *Sharī`ah* law appears not to recognize the concept of mandatory debt write-offs, and debt may only be forgiven voluntarily by the creditor. As a result, debt is not discharged unless it is paid in full by the debtor or other third party who voluntarily assumes such debt, his estate, or the state. The concept of debt write-downs under bail-in, assumes mandatory forgiveness of the portion of the debt written-off, which is forbidden under *Sharī`ah*. It is unclear whether bail-in through debt write-downs could therefore be structured in a manner that is *Sharī`ah* compliant.
- **Equity-debt conversions and the “voluntary debt forgiveness” principle.** Similarly, where bail-in is to be carried out through an equity-to-debt conversion, the “no debt forgiveness” *Sharī`ah* principle may be relevant. An equity-debt conversion that recognizes debt at par value, may in principle not be a problem under *Sharī`ah* law. However, a conversion that recognizes debt at a discount from the par value may be problematic under *Sharī`ah*.

44. *Sharī`ah*-compliant mechanisms for effective application of bail-in should be explored and clarified as part of the design of the resolution framework. Given the potential limitations discussed above, possible *Sharī`ah*-compliant ways of applying the tool should be explored. For example, it is worth considering whether bail-in powers could be

⁴² As mentioned earlier in this paper, risk-sharing is a core element of Islamic finance.

built into Islamic banking contracts (the so-called contractual bail-in approach) and would be considered voluntary debt forgiveness by unsecured creditors under such contracts. In the case of conventional banks, some jurisdictions have used the contractual bail-in approach, under which financial contracts (including contingent convertible bonds or “co-cos”) entered into by banks, contain terms that allow a write-down or conversion of claims by the resolution authorities or the bank itself, when a pre-defined trigger even occurs. Unlike the statutory bail-in approach, this approach relies on contractual arrangements that voluntarily allow bail-in, for example when the bank’s capital falls below a specified level. In the Islamic banking context, however, it is not certain whether the result of such an approach could be deemed equivalent to *Shari`ah*-compliant voluntary debt forgiveness by the bank’s creditors who would have given their consent for bail-in under relevant contracts. While this approach may seem broadly in line with the IFSB’s standards on additional tier 1 and tier 2 structures for *Shari`ah*-compliant bail-in capital,⁴³ clarity would be required in the design of the legal framework, including, in particular, as to whether such contractual consent (given prior to the forgiveness event) would be binding on the parties.

45. Complex and unique structures of the liabilities of Islamic banks may also pose practical hurdles for bail-in. In order for the bail-in tool to be effective, it is necessary for a failing bank to have sufficient debt that can be bailed-in. From a legal standpoint, the extent to which a particular claim can be bailed-in, would depend on the legal nature of the claim. Among other things, the legal treatment of a transaction—in particular, whether it is held as a client asset or as a liability of the bank, and if as a liability, whether secured or unsecured—has implications for its ability to be bailed-in. For example:

- As discussed earlier, PSIAs are typically profit and loss sharing accounts with no guaranteed repayment of principal or returns. Funds standing to the credit of holders of these accounts tend to be treated as client assets. For that reason, bail-in of such accounts by way of mandatory write-down of their face value, or by conversion into equity, may be a challenge as they may not even be recognized as a claim (liability or equity) on the bank’s balance sheet and cannot be used to meet the general liabilities of the failed bank. Unrestricted PSIAs are treated by some jurisdictions (e.g. Turkey) as deposits for financial stability reasons (e.g., for deposit insurance purposes), although it remains unclear how they might be treated in resolution. In any event, the treatment of both restricted and unrestricted PSIAs for purposes of deposit insurance in a jurisdiction, may also have implications for whether these instruments can be bailed in. Where a jurisdiction extends deposit insurance to investment accounts, the

⁴³ IFSB 15 (section 2) “Revised Capital Adequacy Standard for Institutions Offering Islamic Financial Services”, 2013.

insured amount likely would not be bailed-in, in keeping with the protection sought to be offered under the deposit insurance scheme.

- As discussed earlier (paragraph 19 above in connection with PSiAs), PERs and IRRs are held by Islamic banks on behalf of investment account holders. While they belong primarily to account holders (with a residual right of Islamic banks and their shareholders to any undistributed reserves when all investment accounts have been paid their share of the reserves), they have no distinct legal share in these reserves, absent an agreement with an account holder to that effect. In any event, these (apart from the bank's own *pro rata* share) may not represent assets or liabilities of the bank in resolution, and cannot as a general matter be bailed-in.
- The feasibility of bail-in of *sukūk* originated by Islamic banks, is unclear from a legal standpoint.⁴⁴ If the *sukūk* are issued directly by the Islamic bank, they would constitute liabilities of the bank and therefore bail-in would seem feasible. If the *sukūk* are "trust certificates" issued by an SPV established by the bank, they may reflect varying levels of interest in assets held by the SPV for the benefit of *sukūk* holders. Depending on the structure used, the balance sheet of the originating bank under resolution may or may not reflect liabilities in connection with the *sukūk*. In an SPV issuance, proceeds of *sukūk* are passed through the SPV to the bank, in exchange for the purchase or lease of assets transferred to the SPV.⁴⁵ The degree to which *sukūk* issued through an Islamic bank's SPV may be bailed-in would depend to a large extent on the nature of claims (if any) that *sukūk* holders may have against the bank that controls the SPV. This may in turn, depend on the extent to which the transfer of the assets to the SPV constitutes a true sale by the bank. To avoid legal uncertainties, the legal framework for resolution should clarify the treatment of *sukūk* for bail-in purposes. The IFSB⁴⁶ contemplates additional tier 1 and tier 2 structures for *Shari`ah*-compliant bail-in capital whereby *sukūk* could be structured as profit-sharing contracts such as *mushārahah*, *muḍārahah*, or *wakala*, as approved by a *Shari`ah* board. This may however still be a challenge in resolution, given current uncertainties

⁴⁴ The IFSB standards on capital adequacy require that for *sukūk* structures where a legal transfer of assets has not taken place, the applicable risk weighting will be the credit risk weighting of the originator, subject to any *Shari`ah*-compliant credit enhancement by the issuer. An Islamic bank taking the role of an originator is required to hold regulatory capital against all of its retained securitization exposures, including those arising from the provision of credit risk mitigants to a securitization transaction, investments in a securitization originated by it, and extension of a liquidity facility or credit enhancement.

⁴⁵ This reflects the *ijarah sukuk* model, which appears to be popular.

⁴⁶ IFSB 15 (section 2) "Revised Capital Adequacy Standard for Institutions Offering Islamic Financial Services", 2013.

as to true sale concepts (and related bankruptcy and insolvency concepts) under domestic laws.

Table 2: Summary of Selected Islamic Banking Products and Possible Treatment in Resolution

Type	Key Features	Possible treatment (Accounting/Legal)	P&A	Bail-In
Current accounts and <i>qard/wadi'ah</i>	<p>Safekeeping (“deposit”) contracts</p> <p>Resemble conventional deposits, although non-interest/return bearing. May receive gift (<i>hiba</i>) from bank’s capital.</p>	<p>Mostly treated as deposits.</p> <p>Covered by deposit insurance schemes, where they exist.</p>	No major challenge, given treatment as “deposits”	<p>May be eligible for bail-in as deposits, except where covered by deposit insurance, in which case, insured portion may not be eligible for bail-in.</p> <p>However, given <i>Shari'ah</i> prohibition of forced debt forgiveness, current account holders must voluntarily forgive the bailed-in portion of their claims, before a <i>Shari'ah</i> – compliant bail-in could take place.</p>
Profit-Sharing Investment Accounts (PSIAs)	<p>Funds provided by investors and invested in assets by the bank</p> <p>Restricted PSIAs: Funds are invested per account holders’ instructions.</p> <p>Unrestricted PSIA: Funds are invested at the discretion of the bank</p>	Not generally considered deposits.	<p>Except for bank’s profit share (if any), PSIAs likely may not be subject to P&A.</p> <p>May have to be transferred as client assets to a qualifying bank.</p>	<p>Bail-in could be a challenge given that they are not liabilities or equity of bank. However there is no obligation to repay account holders, since they bear the risk of loss jointly with the bank.</p> <p>Some jurisdictions treat unrestricted PSIAs as “deposits” for deposit insurance purposes, and to that extent, may not be feasible to bail-in.</p>
Profit Equalization	Owed to the investment account holders	Attribution to individual account holders would	Except for bank’s residual share (if	Likely not eligible for bail-in, as they

Reserve/ Investment Risk Reserves	collectively, with any residual owed to bank and its shareholders, per contractual terms. Not treated as part of Islamic bank's capital except to the extent of the bank's own share of such reserves (IFSB capital standards).	depend on contractual arrangements.	any), reserves may not be subject to P&A, as they belong to investment account holders. May have to be transferred as client assets, although traceability could be a concern, given co-mingling with liabilities of bank.	may be treated as client assets.
<i>Sukūk</i>	Structured as certificates of participation through securitization of specific assets/pool of assets	<i>Sukūk</i> holders would have ownership interests in the transferred assets and would have no recourse to the bank if there were a true sale. If there were not a true sale, <i>sukūk</i> holders would have no ownership interests in the assets but would probably have residual unsecured claims against the bank for any shortfall upon realization of the assets held by the SPV.	-	If <i>sukūk</i> are issued directly by Islamic bank, bail-in would seem feasible. If issued by bank's SPV, then may not be eligible for bail-in depending on whether there was a true sale of the transferred assets (eligible for bail-in if there was no true sale).

V. MAKING ISLAMIC BANKS MORE RESOLVABLE

46. **Recovery and resolution plans (“RRPs”) are a key component of international reforms to facilitate orderly resolution.** The Key Attributes recommend the use of RRP⁴⁷ to facilitate the effective use of resolution powers, to preserve systemically important functions. RRP help resolution authorities make *ex ante* resolvability assessments by which they can understand complexities and constraints to resolution, posed by the structure of a bank/group or their operations. As the Key Attributes contemplate, the legal framework should empower the resolution authority to require changes in the structure or operations of a bank/group to make it more resolvable.

⁴⁷ Key Attribute 11. A *recovery plan* is developed by the firm's senior management and identifies options for restoring the firm's financial strength and viability when faced with severe stress, while a *resolution plan* is prepared by the resolution authorities, based on information provided by the firm.

47. **The argument for mandating detailed RRPs should hold in the case of Islamic banks.** The complexities posed by Islamic banks' operations and balance sheets should be monitored by resolution authorities. In this regard, well-designed recovery plans would help provide resolution authorities with clear insights into the complex institutional set-up and contractual obligations of Islamic banks, enabling the authority to act swiftly when a bank is failing. Similarly, robust resolution plans prepared by the resolution authority will assist them and their agents (such as official administrators), in their application of various resolution tools and techniques. It would however be important to explore whether RRPs for Islamic banks would need to be pre-cleared by the relevant *Shari`ah* boards, to promote smooth and swift resolution processes.

VI. CONCLUSION

48. **This paper has examined the extent to which international best practices for the design of bank resolution frameworks may be applicable to Islamic banks.** Generally, the paper finds that a number of features contemplated by such international best practices resonate strongly with some relevant *Shari`ah* principles (e.g. risk taking and loss sharing). The paper concludes that the design of legal frameworks for resolution of Islamic banks may need to address specific issues that do not apply to conventional banks. These include the unique governance structure and balance sheets complexities of Islamic banks. While resolution tools may well have broad application for all banks, some adjustments may be required in the case of Islamic banks.

49. **International guidance is needed for the design of legal regimes for effective resolution of Islamic banking operations.** Further analytical work on the potential complexities and uncertainties identified in this paper should be undertaken by relevant international bodies, in close consultation with other standards setters. This effort should help to customize conventional resolution concepts for application to Islamic banks. In the process, harmonization of relevant *Shari`ah* bankruptcy principles, legal and accounting treatment of various assets and liabilities, as well as institutional arrangements for resolution, would be useful.

50. **Making Islamic banks more resolvable should be a key priority for international and domestic reforms.** This would help institutions and resolution authorities be better prepared for dealing with non-viable Islamic banks in an orderly manner, and with the least costs to tax payers. Furthermore, strengthening *Shari`ah*-compliant deposit insurance schemes as well as other financial safety nets, needs to be prioritized to help promote financial stability.

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