Muzakarah on Failure Resolution of Islamic Financial Institutions

PIDM
Perbadanan Insurans Deposit Malaysia
Protecting Your Insurance And Deposits In Malaysia

Session 2

Full Transfer Mechanism: Shariah Issues And Solutions

Presentation
Dr Marjan Muhammad
Acting Deputy President Research
ISRA Research Management Centre
INCEIF University

Content

Introduction

- The aftermath of the global financial crisis (GFC) of 2007–2009 underscored **the critical need for effective resolution frameworks** to mitigate systemic risks and safeguard the stability of the financial sector
- Alandejani *et al.* (2017) revealed that **Islamic banks are more prone to failure than conventional banks,** based on their study of 56 commercial banks in the Gulf Cooperation Countries over 16 years (1995 to 2011).
- PIDM issued **Guidelines on Resolution Planning for Deposit-Taking Members** on 8 September 2023 to delineate PIDM's approach to resolution planning and its requirements.
- PIDM, in collaboration with ISRA Research Management Centre, INCEIF University has conducted a study on the transfer mechanisms in the resolution of Islamic banks in Malaysia.

Introduction (cont'd)

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Research Questions

1. What are the **underlying Shariah concepts** or **principles** relevant to the transfer mechanisms in the resolution of failed Islamic banks?

2. What are the **Shariah issues** arising in the transfer mechanisms during the resolution of Islamic banks?

3. How can the **asset transfer processes** in the resolution of failed Islamic banks be structured, particularly in the context of previous Shariah contracts?

Research Objectives

1. To explore **potential Shariah concepts or principles** for the transfer mechanisms.

2. To **examine** potential Shariah issues pertaining to the transfer mechanisms.

3. To recommend **solutions** that overcome any impediments to the Shariah-compliant transfer of a failed Islamic bank to a new entity.

Resolution of Failed Islamic Banks

There are three key requirements that must be considered in the resolution process of Islamic banks:

01

Existing composition of an Islamic bank's business

02

Transfer mechanisms

03

Applicable Shariah contract(s)

Assets and Liabilities of an Islamic Bank in Malaysia

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The composition of Islamic banks' assets and liabilities in Malaysia:

Assets	Liabilities	Shareholder's Equity
• Cash and short-term funds • Deposits and placements with financial institutions • Investment accounts placement – financing • Financial assets • Financing and advances • Statutory deposits with BNM • Investment in subsidiaries • Investment in associates • Property, plant and equipment	• Islamic deposits from customers • Investment accounts of customers • Deposits and placements of banks and other financial institutions • Investment accounts due to designated financial institutions • Financial liabilities • Provision for zakat and taxation	• Share capital • Retained earnings • Reserves

Islamic Banking Products and Their Underlying Shariah Contracts

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Every transaction and product offering by Islamic banks must be based on an underlying Shariah contract which has its unique features and requirements.

Assets				
Financing		**Cash and short-term fund**	**Deposit and placement**	**Ownership in investment/ partnership**
• *Tawarruq* • *Murabahah* • *Bay` al-inah* • *Bay` al-dayn*	• *Musharakah* • *Mudarabah* • *Wakalah* • *Ijarah* • *Qard*	• *Qard* • *Tawarruq*	• *Qard* • *Tawarruq* • *Wadi`ah yad amanah* • *Wakalah* • *Mudarabah*	• *Musharakah* • *Mudarabah* • *Wakalah*

Liabilities			
Deposit from customer	**Investment account of customer**	**Deposits & placements of IFIs**	**Financial liabilities (e.g. sukuk)**
• *Qard* • *Wadi`ah yad amanah* • *Tawarruq*	• *Mudarabah* • *Wakalah*	• *Qard* • *Tawarruq* • *Wadi`ah yad amanah* • *Wakalah* • *Mudarabah*	• *Bay` al-dayn* • *Tawarruq* • *Wa`d* • *Wakalah* • *Musharakah* • *Mudarabah*

Transfer Mechanisms

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01 FULL TRANSFER

- Transfer the whole business of a failed bank to a new entity, which can be done via a share transfer.
- Failed banks may have homogeneous performing assets such as consumer financings and mortgages that can be packaged and sold in bulk to other banks or investors.

02 PARTIAL TRANSFER

- Transfer of part of the failed bank's assets or liabilities to a private sector purchaser, or temporarily to a bridge institution, with the aim to continue the critical functions.
- The feasibility of such a transfer depends on the availability of a credible purchaser who is willing and ready to take on some of the business of the failed bank.

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Full Transfer

What Is Full Transfer?

- Transfer the **whole business** of a failed bank to a new entity, which can be done via a share transfer.

- Failed banks may have homogeneous performing assets such as consumer financings and mortgages that can be packaged and sold in bulk to another acquirer or investor.

Case Study

	1999	2011	2018	2023
Previous Institutions	• Bank Bumiputra Malaysia • Bank of Commerce (M) • BMMB Kewangan	• Hong Leong Bank • Hong Leong Islamic Bank • EON Capital • EONCAP Islamic Bank	• MBSB • Asian Finance Bank	• MBSB Bank • Malaysian Industrial Development Finance
New Institution	بنك معاملات Bank Muamalat	HongLeong Bank HongLeong Islamic Bank	MBSB BANK	midf A member of MBSB Group

Shariah Issues

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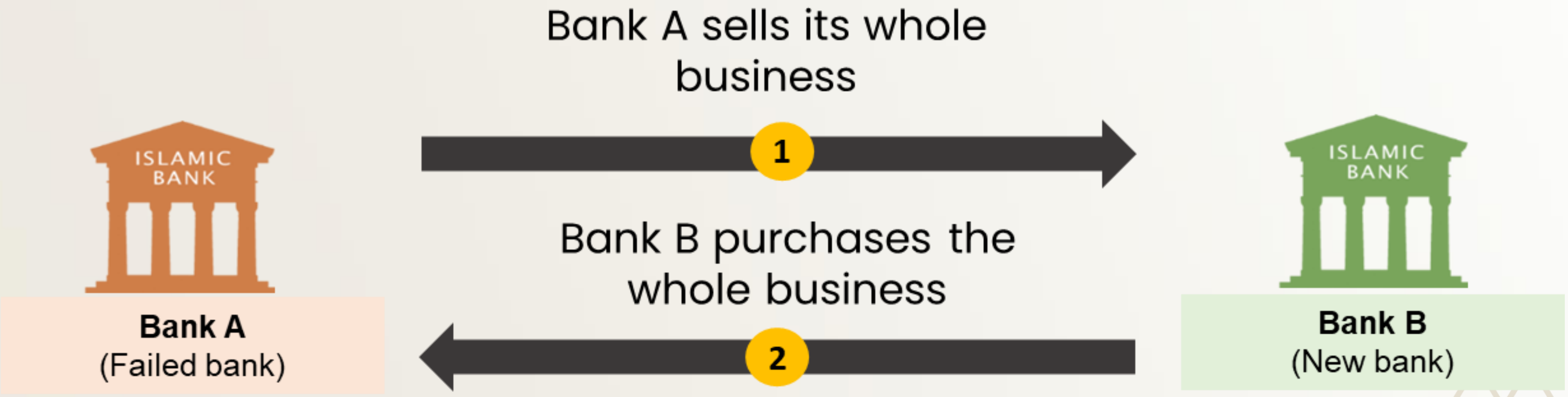
There are several Shariah issues that need to observed:

1. What are the appropriate Shariah contracts for the full transfer of the failed Islamic bank (both assets and liabilities)?
2. What are the Shariah issues that might arise from the proposed transfer mechanism?
3. In full transfer of conventional bank with Islamic window operations, does it require specific Shariah treatment for the Islamic assets/liabilities
4. In the case of a full transfer, is it necessary to review the underlying Shariah contracts of the failed bank's products?
5. Is it necessary to review the composition of the failed bank's assets and liabilities

Solution

What are the appropriate Shariah contracts for full transfer of the failed Islamic bank (both assets and liabilities)?

Option 1: Outright Sale



Solution

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Shariah Justification

AAOIFI Shari'ah Standard No. 59 (sale of debt) states that it is **permitted** to sell such an entity or its share of (the debt) without considering the provisions of the sale of debt.

Transfer process

One of the methods commonly used in bank resolution is the **bidding and auction process** (*muzayadah* or *munaqasah*), which typically occurs when a failed bank's assets and liabilities are being sold or transferred to another entity. The assets and liabilities, which include financing, securities, deposits, physical assets, and any other financial instruments held by the bank, will be assessed and valued. In this regard, PIDM, as the resolution authority, will invite potential buyers, which can include other financial institutions, investors, or other entities, to participate in the bidding process.

AAOIFI Shari'ah Standard No. 59

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8/1 If the debt is part of the assets of an entity that is in existence and has ongoing permissible activities, whether these activities are commercial, financial, industrial, related to real estate, services, agricultural, import-export, sale and purchase of commodities, and the like,

then: it is permitted to sell such an entity or its share (of the debt) without considering the provisions of athe sale of debt in regard to (the portion) of the debts out of its assets whatever would be the ratio of debts, as long as such debts are generated from the turnover (of business). That is because such debts are ancillary to the activity (of the entity).

8/2 If the assets of the Institution include debts, tangible assets, usufructs and rights, and out such assets, the Institution recognised entity wherein **commingling of assets (*khulta*)** is materialised (e.g., a special purpose company or an investment portfolio that is registered with the relevant authorities), and assets of the Institutions are not turned over on an ongoing basis,

then: the Institution may sell or securitise such an entity (entirely or a common share out of it) or issue sukuk thereof, subject to the following rule:

8/2/1 The sale shall result in (its respective) Shariah effects, including transfer of ownership and risk to the buyer, as the buyer shall bear the risks (associated with) the asset. It is not permitted to stipulate that such risk will be borne by the seller at any stage of the process.

Other Options That Have Been Assessed

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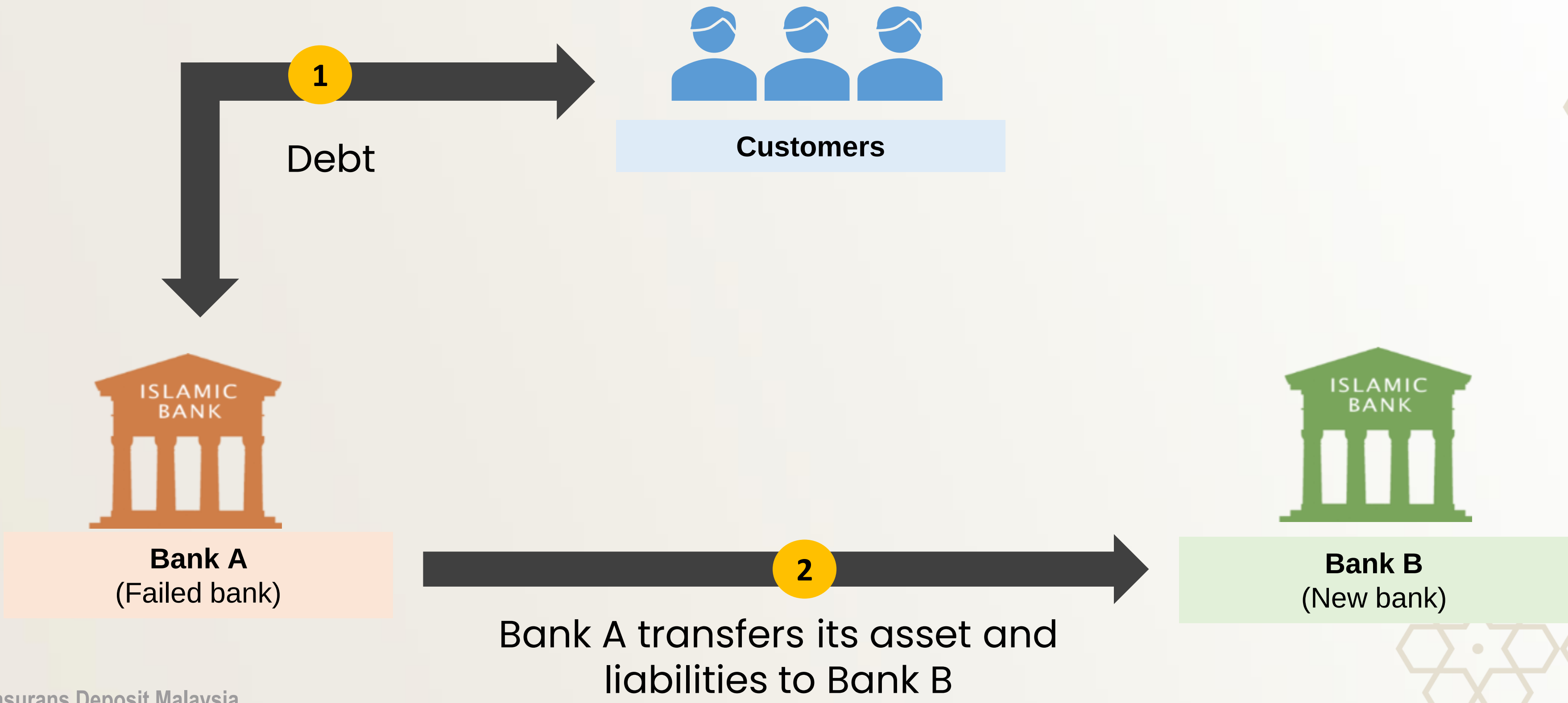
Option 2: Hawalah



Other Options That Have Been Assessed (cont'd)

Shariah Justification

IFSB TN-4 - The ideal way of performing asset transfers and bridge banking is to transfer a debt to a new assignee (a solvent bank or a bridge bank), as found in the ***hawalah*** contract.

- This contract allows a **debtor to assign his obligation to another debtor**, without the creditor's consent, so long as that assignee party is solvent.
- This could work on both sides of the balance sheet: liabilities (where the failed IFS is the debtor) and assets (where the clients are the debtors), including an Insertion in the contract that allows for *hawalah*-type transfer to take effect to an appropriate assignee (third-party bank or bridge bank) as per the resolution authority's decision and best judgment.

DSN-MUI recommends the use of a *hawalah* contract in the case of transferring an Islamic bank's liabilities and/or assets to another entity. However, the **transfer of debt can only be executed at par**. Therefore, any discount or premium applied to this transaction will be considered *riba* and thus be impermissible.

Other Options That Have Been Assessed (cont'd)

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Arising Issues

- Given the inherent structure of *hawalah*, which requires pre-existing indebtedness before executing the transfer, it might **not be a suitable contract for full transfers** that encompass the assets and liabilities of a failed Islamic bank.
- The liability side of Islamic banks also includes investment accounts (either restricted or unrestricted), whose underlying assets belong to the investment account holders (IAH) and not owned by the Islamic bank.
- The *hawalah* contract is only applicable to the transfer of rights over a debt.

Recommendation

- The research proposes the use of an **outright sale** in the case of full transfer of a failed bank to a new private entity.

- The mode of sale and its price can be executed according to the mutual agreement between the seller and buyer.