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

Panel discussant(s) presentation

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Commenting on Full Transfer Mechanism: Shariah Issues and Solutions

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1. INTRODUCTION

Firs of all, I would like to thank Dr Marjan Muhammad for her presentation on very crucial topic on Transfer Mechanism: Shariah Issues and Solutions. The presentation has covered important key points which cover, introductory key points, Assets and Liabilities of an Islamic Bank in Malaysia, Islamic Banking Products and Their Underlying Shariah Contracts, Resolution of Failed Islamic Banks which includes: Existing composition, of an Islamic bank's Business, Transfer Mechanism and applicable Shariah Contracts. Transfer Mechanisms, Full and Partial. This is the core discussion where few aspects have been discussed, supported with cases by highlighting some important Shariah issues under the matter. Two main options have been provided which are: Outright Sale and Hawalah, where some key concerns has been addressed in these contracts such as sale of debt. The researcher recommends the Outright Sale as the best option for the case of full transfer of a failed bank to a new private entity

We appreciate the contribution and the finding. However, in addition to have been mentioned, I would like to add few supporting key aspects that widen the scope of discussion on this matter as follows.

When an Islamic bank fails, the resolution process involves a series of mechanisms to ensure that the bank's assets, liabilities, and operations are handled in a manner consistent with Shariah principles, while protecting the interests of depositors, creditors, and the broader financial system. This is different from the transfer of business during normal operations, where the bank continues to operate without distress or failure. The failure resolution of Islamic Financial Institutions (IFIs), like their conventional counterparts, involves structured mechanisms to manage the orderly transfer of their business, assets, and liabilities. These mechanisms are designed to ensure stability in the financial system, protect depositors, and maintain trust in the financial sector.

2. BUSINESS TRANSFER: FULL OR PARTIAL BUSINESS TRANSFER:

In case of failure, the business operations of an Islamic bank can be fully or partially transferred to another financial institution. This can involve transferring specific types of assets and liabilities, such as deposits, investments, or financing products, while ensuring compliance with Shariah principles.

The resolution framework for IFIs must adhere to Shariah principles, making the process distinct from conventional methods.

3. THE KEY AREA OF CONSIDERATION OF BUSINESS TRANSFER

The key area of consideration of business transfer are as follows:

3.1. BUSINESS TRANSFER HAS TWO SCENARIOS

A. Business Transfer During Normal Operations: A transfer of business involves a transaction where an Islamic bank transfers part or all of its business, assets, or liabilities to another entity without the bank being in distress or facing imminent failure. This can occur during a merger, acquisition, or strategic realignment.

The objectives of such scenario are as follows:

- Facilitate growth, consolidation, or strategic alignment with market opportunities.
- Improve operational efficiency or expand the bank's market presence.
- Restructure or reallocate resources without the pressure of financial distress.
- Achieve better compliance or risk management.

Mechanisms for Business Transfer:

- **Merger or Acquisition (M&A):** The Islamic bank merges with or is acquired by another institution. Both entities' Shariah boards typically ensure compliance throughout the process.
- **Asset Sale:** The bank sells specific assets to another financial institution or investor. The assets must be free of Riba (interest), Gharar (excessive uncertainty), and other non-compliant elements.
- **Spin-Off:** A portion of the bank's business is separated to form a new entity. Both the parent and new entities must maintain Shariah compliance.
- **Joint Venture:** An Islamic bank may partner with another entity to share business operations, benefiting from each other's strengths.
- **Internal Restructuring:** The bank may realign its internal operations or transfer certain functions (like Islamic insurance or takaful) to subsidiaries or affiliates.

B. Resolution of a Failed Islamic Bank: This process occurs when an Islamic bank is no longer viable and cannot continue operations due to insolvency, lack of liquidity, or severe financial distress. The resolution process is triggered by regulatory authorities to protect the stability of the financial system.

The objectives of such scenario are as follows:

- Protect depositors' funds, especially unrestricted investment account holders (UIAHs) who share in the profit and loss.
- Ensure continuity of critical banking functions while minimizing disruption to the financial system.
- Preserve the Shariah-compliant nature of transactions.
- Avoid reliance on taxpayer-funded bailouts (no "bailout" by the government).

Mechanisms for Resolution:

- **Bail-In:** Creditors and shareholders absorb the bank's losses. Depositors (especially UIAHs) might have to share in the losses, in accordance with Shariah principles, since they are risk-sharing participants.
- **Purchase and Assumption (P&A):** Another financial institution purchases the failed bank's assets and assumes its liabilities. This process must ensure the Shariah-compliant nature of assets and liabilities.
- **Bridge Bank:** A temporary bank is created by regulators to maintain essential banking services while a more permanent resolution is sought.
- **Asset Management Company (AMC):** An AMC can be set up to take over the problematic assets of the failed bank, manage them, and liquidate them in a Shariah-compliant way.
- **Shariah-Compliant Liquidation:** The bank's assets are sold off, and the proceeds are distributed to creditors in accordance with Shariah principles. Debts must be repaid before equity holders receive anything.
- **Conversion to an Islamic Business Model:** If an Islamic bank fails due to issues unrelated to its Shariah compliance, it may undergo restructuring under a new business model while maintaining its Islamic character.

Key Differences Between Resolution and Normal Business Transfer:

Aspect	Resolution of a Failed Islamic Bank	Business Transfer During Normal Operations
Trigger	Bank is in financial distress or insolvent	Strategic decision, growth, or realignment
Objective	Protect depositors, maintain stability, avoid taxpayer bailout	Achieve growth, efficiency, compliance, or market expansion
Mechanism	Bail-in, P&A, bridge bank, AMC, liquidation	Merger, acquisition, asset sale, spin-off, joint venture
Regulatory Involvement	High; often led by central bank or resolution authority	Moderate; subject to approval but less intrusive
Shariah Compliance Focus	Ensures Shariah principles in resolution methods, such as handling assets/liabilities	Ensures Shariah compliance in transfer terms and structures
Impact on Stakeholders	Depositors, creditors, and shareholders may face losses	Minimal impact; may provide strategic benefits to stakeholders

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3.2. CONSIDERATION OF THE SALE AS TRANSFER MECHANISM

When selling the assets and liabilities of an Islamic bank, several Shariah-related issues can arise. These issues primarily revolve around ensuring compliance with Islamic principles, which prohibit elements like Riba (interest), Gharar (excessive uncertainty), and Haram (forbidden activities).

The area of concerns are as follows:

3.2.1. Assessment and evaluation: Assessment, analysis, and evaluation of the composition and portfolio of the bank, which include the assets and liabilities. The valuation of the assets is addressed through:

- **Fair Valuation**: The valuation of assets and liabilities must be fair and just, considering their current market value, the potential for future earnings, and any risks involved. This is especially relevant for Islamic banks that may have assets with different Shariah statuses, such as real estate, Islamic bonds (Sukuk), and equity in companies.
- **Appraisal Process**: The process of appraisal must comply with Shariah principles, ensuring that all parties involved agree on the valuation methods and outcomes.
- **On balance sheet and off-balance sheet**: On-balance sheet items are the assets, liabilities, and equity directly recorded on the bank's balance sheet. Off-balance sheet items refer to commitments, contingencies, or other financial obligations that are not directly recorded on the bank's balance sheet but can impact its financial position.

3.2.2. Assessment and evaluation of the debts and receivables: The assessment and evaluation of the debt will determine the level of debt in the portfolio of the bank.

The level of debt will determine the nature of sale that could be suggested:

A. **If the level of debt is below 50%:** This will be considered as sale and the debt level will be regarded as part of the overall asset without specific treatment of that particular debt.

- العبرة للمتبوع دون التابع
- الأصول مبينة على أن الأقل تبيع للأكثر
- التابع لا يفرد بحكم
- العادة جارية بأن القليل إذا انظم إلى الكثير في حكم الملغى قصدا فكان كالملغى حكما

B. **If the level of debt is above 50%:** If the debt level in the bank portfolio subject to sale is above 50%, the sale will be based on Sale of Debt (Bay' al-Dayn). The execution of Sale of Debt (Bay' al-Dayn) will be using Bay' al-Dayn bi Sila'.

3.2.3. Possibility of Mixing of Permissible and Impermissible Assets (Assets Composition): If the assets of the Islamic bank include a mix of Shariah-compliant (halal) and non-compliant (haram) elements, hence treatment should be given to non-permissibility asset.

3.2.4. Ensuring Transparency and Avoidance of Gharar (Uncertainty): This will be addressed through:

- **Clarity in Contract Terms**: All terms and conditions of the sale must be clear, transparent, and free from excessive uncertainty (Gharar). Any ambiguity in the nature of the assets, their valuation, or the details of the transfer could render the transaction non-compliant.
- **Due Diligence**: Full disclosure of the assets' status (e.g., current market value, potential risks) is required to ensure there is no deception or unfair advantage.

3.2.5. Shariah Compliance contract: The contracts used in the transaction should be carefully addressed. This includes:

- **Clear and Detailed Contract**: The sale agreement should clearly state all terms and conditions, ensuring there is no ambiguity (Gharar). It should outline the details of the assets and liabilities being transferred, the payment terms, and any contingencies or conditions attached to the sale.
- **Review of Contracts**: The sale of assets that involve Islamic financial instruments (like Murabaha, Ijara, Mudaraba, Musharaka, etc.) requires careful review to ensure that the underlying contracts and their execution comply with Islamic law.
- **Sukuk and Equity Investments**: If the bank's assets include Sukuk (Islamic bonds) or shares in companies, their compliance must be verified. The issuing companies and their activities must also comply with Islamic principles.

3.2.6. Treatment of Zakah: The portfolio of the bank zakah could be within the portfolio of the bank, which should be treated and addressed carefully. If there are zakat liabilities or unpaid obligations on the bank's assets, these must be settled according to Shariah rules before the sale or transfer takes place.

3.2.7. Handling Prohibited Income: Any income derived from non-compliant activities (like interest income) must be identified and purified through donation to charity before completing the sale.

3.2.8. Compliance with Shariah Governance: Compliance with Shariah Governance is part of the process of the transaction. This could be addressed through the following:

- **Shariah Board Approval**: The sale must be reviewed and approved by the bank's Shariah Supervisory Board to ensure all elements are compliant. This includes reviewing all underlying contracts, financial instruments, and the methods used for valuation and transfer.
- **Continuous Monitoring**: Even after the sale, there should be mechanisms in place to monitor and ensure that the transfer and usage of the assets remain within the bounds of Shariah compliance.

3.2.9. Post-Sale Integration and Restructuring: Upon the completion of the sale transaction, post sale consideration should be addressed as follows:

- **Maintaining Shariah Compliance Post-Sale**: The acquiring entity must ensure that all assets and liabilities remain compliant post-sale. This may involve restructuring certain contracts or business practices to align with Islamic principles.
- **Ongoing Shariah Governance**: The acquiring entity should have a Shariah governance framework, including a Shariah Supervisory Board, to oversee the integration process and ensure continued compliance.

3.2.10. Adherence to Local Laws and Regulations: While the sale must comply with Shariah, it also needs to adhere to local legal and regulatory requirements. The transaction should not contradict local laws, and necessary approvals must be obtained from regulatory bodies.

3.3. THE FRAMEWORK OF THE SALE

The framework of the sale is not considering as normal sale but it is a special sale that could be under بيع المضطر أو بيع المكره

3.3.1. *Bai`* Muzayadah as process for the sale execution

Bai` Muzayadah is the offering of goods for sale in a market by a seller with a number of interested buyers who compete to offer the highest price. This process ends with the seller selling the goods to the highest bidder. *Bai Muzayadah* is similar to an auction. Other names for this principle used by past Islamic jurists are *bai` Fuqara', bai` man Kasadat Bidha`atuhu, bai` Mahawij*, and *bai` Mafalis*.

Bai` Muzayadah is a form of trading that has existed and been applied in the *Muamalat* system for a long time and practiced by the Prophet (ﷺ).

- (a) Imam Bukhari had written a specific topic on the concept and views of `Ata' who said that *bai` Muzayadah* was practised by society in the sale of war booty; and
- (b) Anas had reported the Prophet (ﷺ) selling a carpet and a water vessel and was calling out for customers. A man offered to buy them for one dirham. The Prophet (ﷺ) then asked for a higher bid. Another man offered two dirham and so the Prophet (ﷺ) sold the wares to him.

3.3.2. Bai Muthar and Bai al Mukrah

The transaction of sale could be under the purview of Bai Muthar and Bai al Mukrah.

- **Bai Muthar:** He who is forced: a person is forced to sell something because he needs money; This is to pay off a debt that has burdened him or his supplies are exhausting him, so he sells for a deficiency out of necessity. Its ruling: It is a valid and enforceable sale, and its effects include the transfer of the sold item and ownership of the price. Ibn Hazm said: The (Muthar) forced sale was made by mutual consent, and no one forced him to do it, so it is valid according to the text of the Qur'an. Al-Shawkani said: It is not permissible for a Muslim to take advantage of his necessity to sell, so he buys it from him without its value.
- **Bai al Mukrah (Forced sale):** Forcing a person to do something without his consent. It is forcing a person to sell something that he does not want to sell. As for its ruling, it is in detail. Coercion to sell by right: in which a person is forced to sell something, but it is coercion by right, and forms of this include selling the asset of something to settle his debt.

Therefore, the sale of bank assets and liabilities should be under the framework of Bai Muthar and Bai al Mukrah where due consideration on justice, fairness and interest protection should be strongly considered in the process

Conclusion

Selling an Islamic bank, including its assets and liabilities, is a complex process that requires careful consideration of Shariah principles. The transaction must be thoroughly reviewed by Shariah experts, ensuring compliance with Islamic contracts, fair valuation, transparent disclosure, and adherence to the objectives of Shariah. It is crucial to handle all assets, liabilities, debts, and mixed elements in a manner that aligns with Shariah requirements to ensure the transaction is valid, fair, and beneficial for all parties involved.