Session 3

Partial Transfer Mechanism: Shariah Issues And Solutions

Presentation

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

Content

Partial Transfer

Introduction

Muzakarah on Failure Resolution of Islamic Financial Institutions

- Islamic banks are also **not immune** to the risk of failure. A few Islamic banks have experienced financial distress, requiring responses by national authorities, either via full transfer or partial transfer.
- For partial transfer, the separation of good and bad assets serves as a key strategy to mitigate systemic risks while preserving the essential functions of the banking sector. The creation of good banks and bad banks allows for the efficient transfer of viable components to entities capable of revitalisation, while distressed assets are managed and disposed of in a controlled manner (Dorothea & Klaus, 2009).
- Studies showed that partial transfers involving Islamic entities also **follow the conventional method**, like the full transfer arrangement. However, there is no detail on any Shariah contract(s) used in the process.

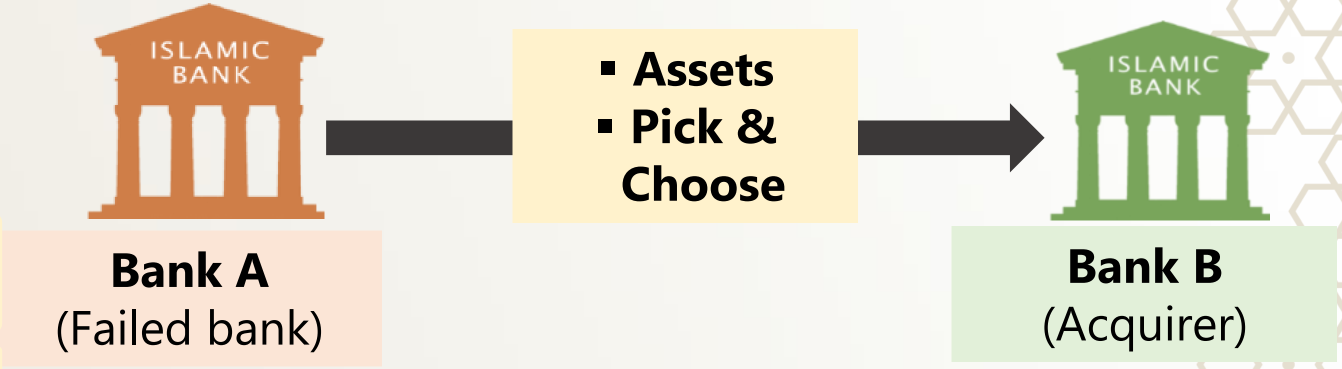
What Is Partial Transfer?

Muzakarah on Failure Resolution of Islamic Financial Institutions

- The transfer of part of the failed bank to other entities may involve **assets, liabilities or/and shares**. 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.

Assets	
Financing	Deposit & Placement
Cash and short-term fund	Property & equipment
Ownership in investment/ partnership	

Liabilities	
Deposits and placements of banks and other financial institutions	
Investment accounts of customers	
Financial liabilities	Islamic deposits from customers



Case Study

Muzakarah on Failure Resolution of Islamic Financial Institutions

2022

Previous Institutions

citibank

New Institution

UOB

Transfer process

The transfer of the consumer banking business comprising assets and liabilities (Islamic portfolio) from Citibank to UOB

Shariah Issues

Muzakarah on Failure Resolution of Islamic Financial Institutions

There are several Shariah issues that need to observed:

1. What are the appropriate Shariah concepts for the partial transfer of the failed Islamic bank (assets only)

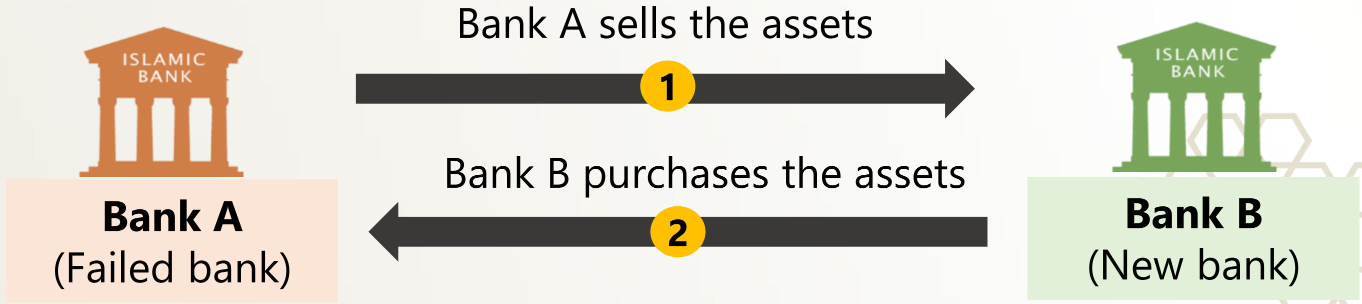
2. What are the appropriate Shariah concepts for the partial transfer of the failed Islamic bank (picking and choosing assets and liabilities)?

3. What are the Shariah issues that might arise from the proposed transfer mechanism?

Solution 1

What are the appropriate Shariah concepts for the partial transfer of the failed Islamic bank (assets only – non-debt/tangible)

Outright Sale



- Similar to the outright sale for full transfer, the mode of sale and its pricing can be mutually agreed by the contracting parties.

- **Application:** The selection of the appropriate Shariah contract depends on the suitability and status of the asset including pricing arrangement. For example, it is normal for asset sales during a stress condition to experience a haircut; thus, *wadi`ah* may be the preferable form, with due consideration of the 'no creditor worse off' concept. The *musawamah* contract is another viable option that can be explored whereby both parties will agree on the price.

Solution 2

Muzakarah on Failure Resolution of Islamic Financial Institutions

What are the appropriate Shariah concepts for the partial transfer of the failed Islamic bank (picking and choosing assets and liabilities)?

- The partial transfer of a failed Islamic bank, particularly the process of selectively transferring assets and liabilities, requires a detailed Shariah analysis.
- In this case, where there is a need to pick and choose specific assets and liabilities for transfer, various perspectives and Shariah concepts need to be considered

Portfolio	Spot Payment	Deferred Payment
Tangible assets only	Outright sale	Outright sale
Mixed Tangible Assets and Liabilities		
• Tangible assets are more than 50%	Outright sale	Outright sale
• Tangible assets are 50% and below	1. Bay` al-dayn 2. Bay` al-dayn bi sila`	1.Hawalah + sale 2.Hawalah + tawarruq 3.Hibah + tawarruq

<u>Scenario 1:</u> Tangible assets only: Payment on spot and deferred.

- If the partial transfer involves tangible assets only, an outright sale can be executed, like in the case of full transfer and partial transfer of assets only.

<u>Scenario 2:</u> Mixed assets (tangible and debt) and tangible is more than 50%: Payment on spot and deferred.

- In this scenario, an outright sale can be adopted for both spot and deferred payment. The Shariah basis for allowing the tradability of such assets is derived from the ruling of predominance, which says:

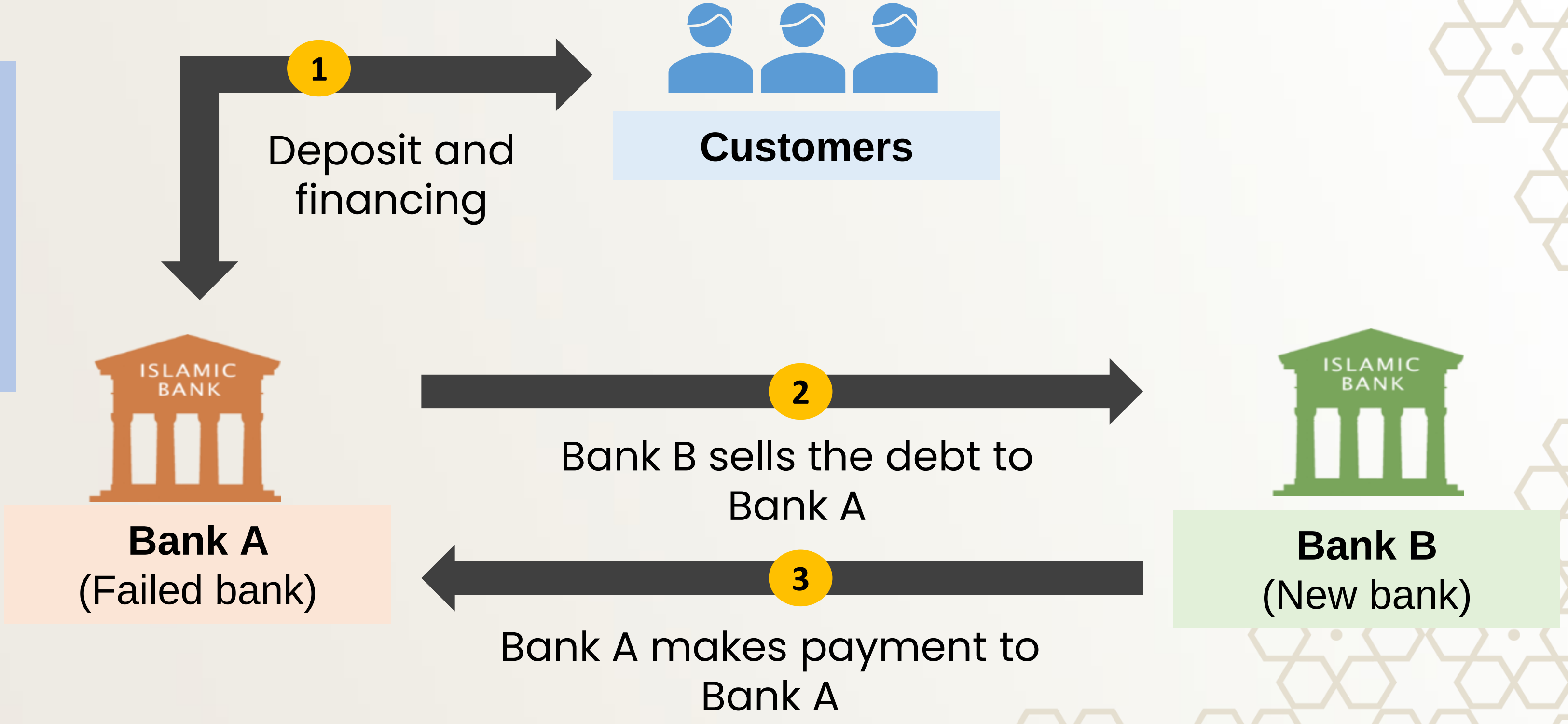
الأَكْثَرُ يَقُومُ مَقَامَ الكُلّ

'The [ruling for the] majority applies to the whole'

<u>Scenario 3:</u> Mixed assets (tangible and debt) and tangible assets are 50% and less: payment on spot

In this scenario, the concept of *bay` al-dayn* can be employed, using two modes:

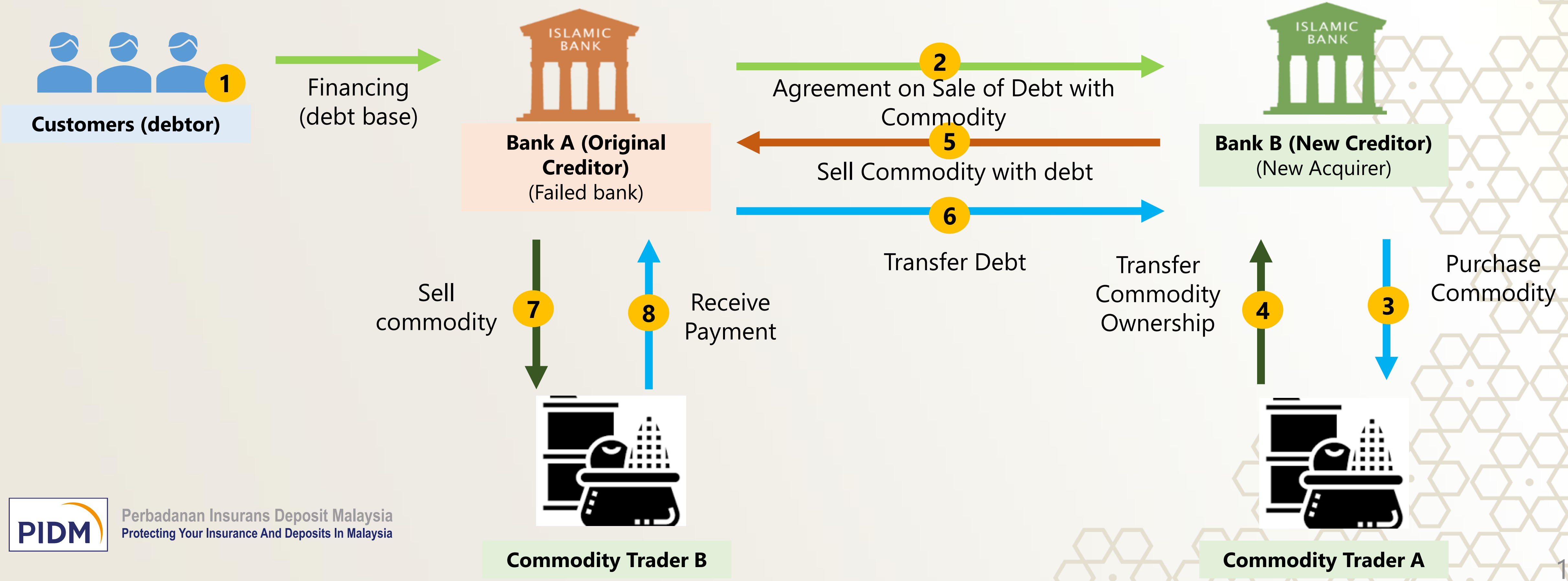
1) For scholars who allow a sale of debt to a third party at discount, the debt can be sold for cash



Muzakarah
on Failure Resolution of Islamic Financial Institutions

2) For scholars who disallow a sale of debt to a third party at a discount with cash, *bay` al-dayn bi al-sila'* can be employed.

Bay` al-dayn bi sila' **-** Arrangement to purchase the debt from the creditor (settlement in cash)



<u>Scenario 4:</u> Mixed assets (tangible and debt) and tangible assets are 50% and less: payment on deferred

- In this scenario, the issue of sale of debt with debt will arise. As a way out, **three options—** using a hybrid arrangement to transfer the mixed assets from the failed Islamic bank to the new entity on a deferred payment basis —are proposed.

Muzakarah on Failure Resolution of Islamic Financial Institutions

OPTION 1: Mechanism for the Combination of *Hawalah* and Sale

Customers

1 Deposit and financing

Transaction 1

Deposit
Debt

Bank A (Failed bank)

1 Bank A transfers (*hawalah al-dayn*) the debt owed to Customers to Bank B

Bank B (New Acquirer)

Transaction 2

Financing
Debt-based

Bank A (Failed bank)

1 Bank A transfers (*hawalah al-haq*) its debt (owed by Customers) to Bank B

Bank B (New Acquirer)

Transaction 3

Financing
Non-debt

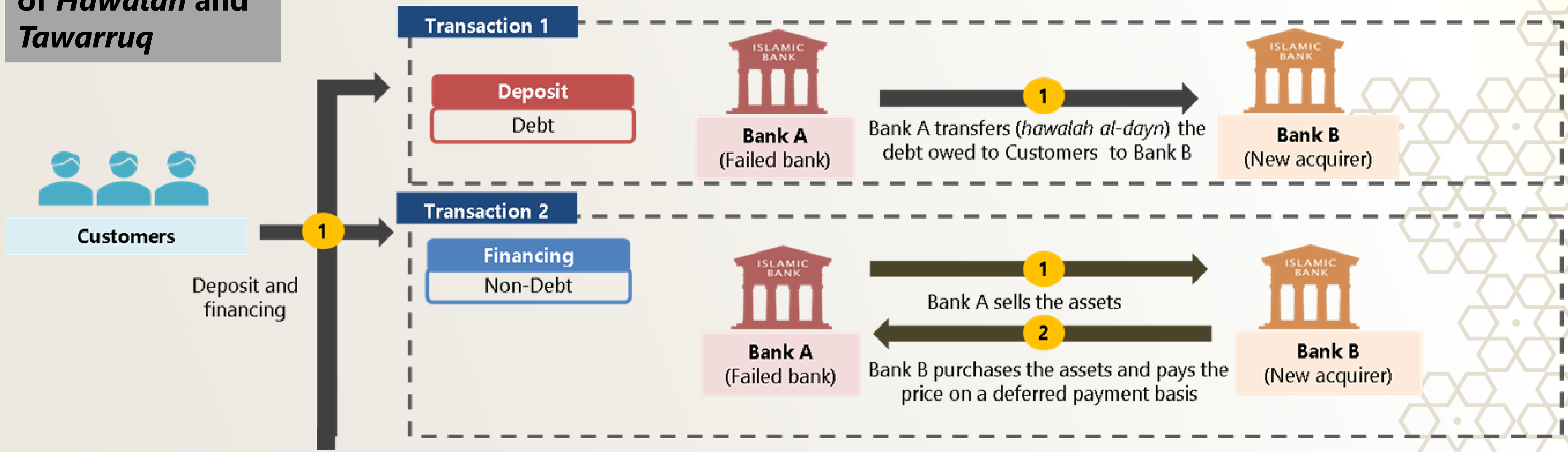
Bank A (Failed bank)

1 Bank A sells the assets

2 Bank B purchases the assets and pays the price on a deferred payment basis. The price is determined by the overall value of the portfolio.

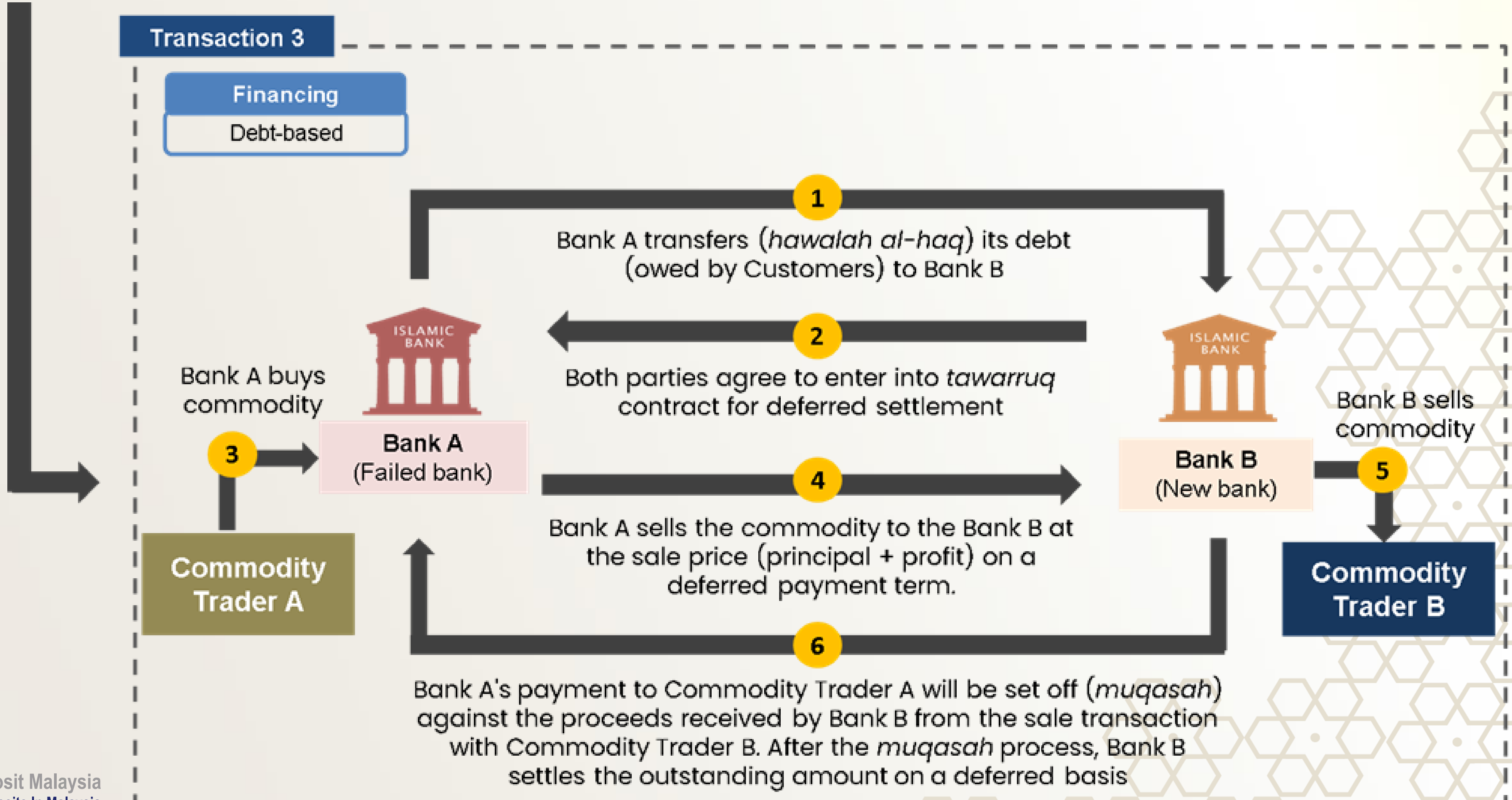
Bank B (New Acquirer)

OPTION 2: Mechanism for the Combination of *Hawalah* and *Tawarruq*



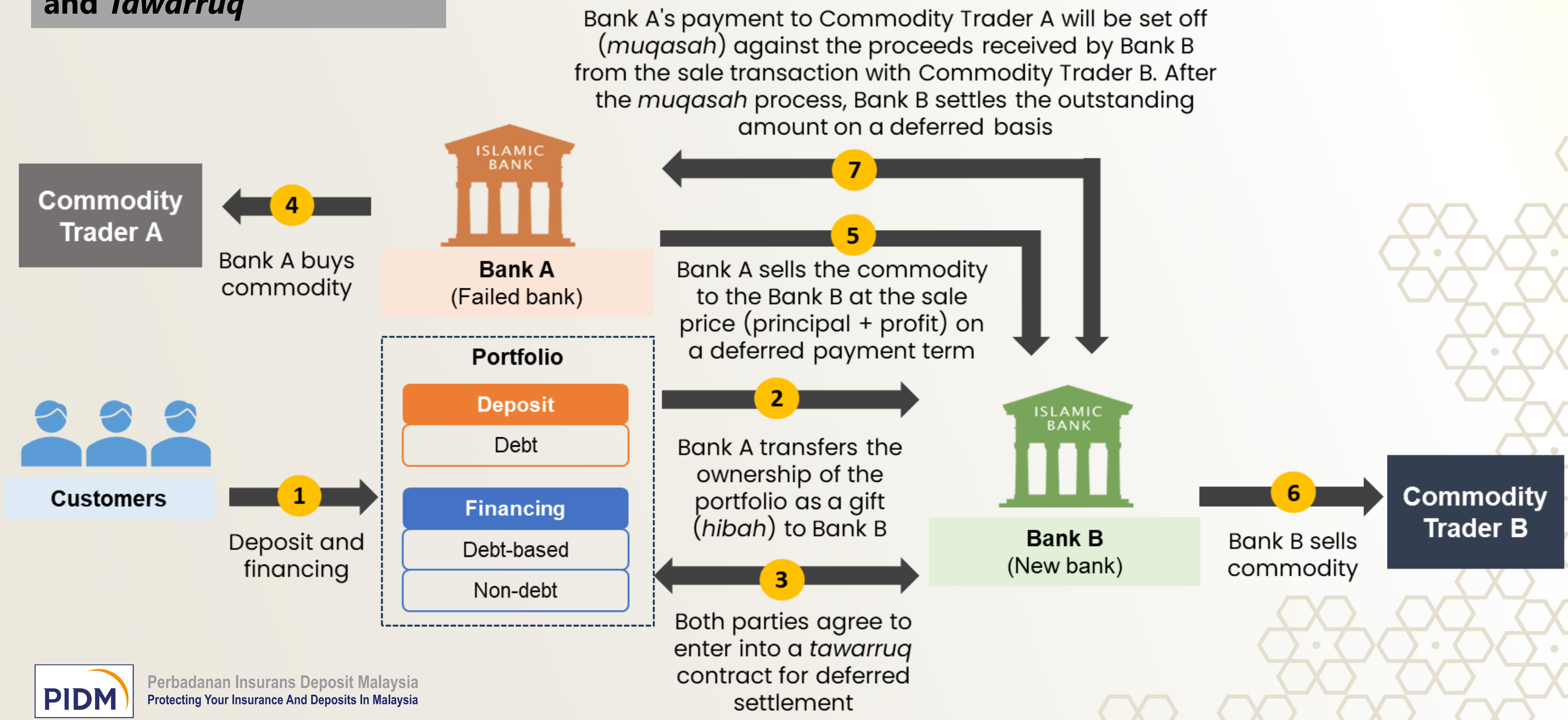
Muzakarah on Failure Resolution of Islamic Financial Institutions

OPTION 2: Mechanism for the Combination of *Hawalah* and *Tawarruq* (cont'd)



OPTION 3: Mechanism for the Combination of *Hibah* and *Tawarruq*

Muzakarah on Failure Resolution of Islamic Financial Institutions



The proposed options would require further scrutiny to address the following potential Shariah issues

The combination of contracts may result in the contracts being **contingent upon each other**, especially in Option 2 where there is a potential issue of dependency of the contracts despite both being executed separately.

The combination of contracts **may lead to the element of *riba***, especially in Option 3 where there is a potential issue of giving gift for consideration (*hibah bi al-thawab*).

The combination of contracts may invoke the potential issue of **fictitious contracts** being employed to legalise the transfer.

Recommendation

- For partial transfer of both assets and liabilities (the pick-and-choose approach), different Shariah concepts such as **outright sale, sale of debt, debt transfer, gift and *tawarruq*** can be applied depending on the composition of the asset or liability portfolios as well as the mode of payment.

- For a failed Islamic bank that adopts the AAOIFI approach on the sale of debt, it needs to calculate the composition of tangible assets (physical and non-debt assets), and intangible assets (i.e., debt).

- If the tangible assets are 50% and below, only the sale of debt with commodities on a spot basis is allowed. On the other hand, if tangible assets are more than 50% of the entity's total assets, an outright sale can be adopted, either spot or deferred payment.