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The World Bank Legal Review

Volume 5

Fostering Development through Opportunity, Inclusion, and Equity

Edited by
Hassane Cissé
N. R. Madhava Menon
Marie-Claire Cordonier Segger
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The World Bank Legal Review is a publication for policy makers and their advisers, judges, attorneys, and other professionals engaged in the field of international development with a particular focus on law, justice, and development. It offers a combination of legal scholarship, lessons from experience, legal developments, and recent research on the many ways in which the application of the law and the improvement of justice systems promote poverty reduction, economic development, and the rule of law.

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Specialized Insolvency Regimes for Islamic Banks

Regulatory Prerogative and Process Design

Hdeel Abdelhady

The failures of large financial institutions in 2007 and 2008 revealed the inadequacy of existing insolvency regimes to resolve failed firms while limiting the impact to the financial system, public funds, and market confidence.[1] In response, governments have studied and adopted measures to better manage the insolvency of financial institutions, with a focus on systemically important financial institutions (SIFIs) and attention to smaller firms. In the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act created a special framework for the resolution of systemically important financial companies.[2] In the United Kingdom, the Banking Act 2009 established a Special Resolution Regime to facilitate the swift and orderly resolution of failed firms.[3] Multilaterally, the G20 Financial Stability Board has moved to strengthen and standardize resolution frameworks.[4] These measures share common policy objectives; namely, the timely detection of risk, early regulatory intervention, the avoidance of government bailouts and related moral hazard, and enhanced market discipline.

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1 In this chapter, Arabic terms such as *mudaraba*, *mudarib*, and *Shari'ah* appear with alternative phonetic spellings, due to differences in spelling between the author and some quoted sources. Because the differences are minor and the meanings remain clear, source spellings are intact. The terms *Shari'ah* and *Islamic law* are used interchangeably.

2 Orderly Liquidation Authority (OLA) under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 12 U.S.C. and 15 U.S.C.) (hereinafter Dodd-Frank). In this chapter, OLA, a substantively harmonized and administratively managed resolution regime, is discussed as a framework of reference for the design of insolvency regimes for Islamic banks, which, like some financial companies subject to OLA, straddle banking and capital markets and are well-suited for insolvency frameworks that combine banking and capital market rules and administratively managed insolvency processes

3 Banking Act 2009, 2009, ch. 1, secs. 90–122 (Eng.). *See* also, for a brief overview, Her Majesty's Treasury, *Banking Act 2009 and the Establishment of the Special Resolution Regime*, available at http://www.hm-treasury.gov.uk/fin_stability_bankingact_srr.htm (accessed May 2, 2013). Notably, the Special Resolution Regime includes resolution mechanisms used in the United States for decades, such as bridge banks and regulator-brokered transfers of failed bank assets and liabilities to healthy firms.

4 *See*, for example, Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Oct. 2011), enumerating the "core elements . . . necessary for an effective resolution regime."

Notably, Islamic banks and other Islamic financial institutions have been absent from recent discussions on the resolution of failed banks.[5] This is not unexpected. Islamic financial institutions are not—individually or collectively—sufficiently large or interconnected to qualify for SIFI status.[6] But there is no reason to wait for Islamic banks to become systemically important to adopt regimes for their resolution. Islamic banks are not yet "too big to fail," but they are too young to risk failure.[7] Many governments, in Muslim-majority and other jurisdictions, have embraced Islamic banks, but only half-heartedly: they have taken steps to attract funds through Islamic finance, but have yet to construct the legal and regulatory infrastructure needed to support its sustainable growth within their borders. This approach has proved passable, but it is neither legally sustainable nor economically optimal. Particularly in Muslim-majority jurisdictions, Islamic banking has the potential to boost economic and finance sector development and financial inclusion. To realize this potential, enabling legal and regulatory environments are required to facilitate the sustainable growth of Islamic banking. Such environments must include insolvency regimes for Islamic banks that, like other well-crafted regimes promote market confidence, allow for early detection of risk and regulatory intervention, and impose market discipline on Islamic banks and their counterparties, including by necessitating, if not mandating, improved disclosure and contracting practices.

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5 Although the World Bank and the Islamic Financial Services Board (IFSB), an Islamic financial services standard-setting body, have explored "[e]ffective insolvency regimes for Islamic financial institutions," with a focus on framing some of the issues.

6 Information about the systemic importance of Islamic banks has been, and is, relatively scant. For example, the authors of a 2008 International Monetary Fund (IMF) publication believed their paper was "the first to provide a cross-country empirical analysis of the role of Islamic banks in financial stability." Martin Čihák & Heiko Hesse, *Islamic Banks and Financial Stability: An Empirical Analysis* 3 (International Monetary Fund Working Paper No. WP/08/16, 2008). Available literature on Islamic banks and financial stability is based on theoretical models, rather than on "formal empirical analysis." (*Id.,* at 5.)

7 Uncertainty as to the nature of Islamic financial instruments and investor rights at default has had a chilling effect. For example, the *sukuk* market was adversely affected by a leading Shari'ah scholar's 2007 opinion raising doubts about the legality of some *sukuk* (commonly described as "Islamic bonds") then on the market. *See,* for example, Robin Wigglesworth, *Sharia Boards: Scholars Hold Sway over the Success of Products*, Financial Times (May 5, 2009), available at http://www.ft.com/cms/s/0/91c1636e-3836-11de-9211-00144feabdc0.html#axzz2UMouSeaW (accessed May 5, 2013). Dubai World's November 2009 request to halt debt repayments, including payments to holders of a $3.5 billion *sukuk* issued by the property developer Nakheel, exposed uncertainty as to the legal rights and obligations of *sukuk* holders in default or other distress. *See,* for example, Heiko Hesse & Andreas Jobst, *Debriefing Nakheel: Wider Implications for the Sukuk Market*, Roubini Global Economics, Economonitor (Apr. 29, 2010), available at http://www.economonitor.com/blog/2010/04/debriefing-nakheel-wider-implications-for-the-sukuk-market/ (accessed May 5, 2013). In banking, some Egyptian consumers and regulators remain skeptical of Islamic banking as a result of decades-old fraud cases involving Islamic institutions. *See,* for example, *Flirting with Islamic Finance*, *infra* note 21 ("For many years, Egyptians have had reservations against Islamic finance, after firms like Al-Rayan and Al-Saad stripped thousands of Egyptians of millions of pounds in Ponzi schemes in the mid-1980s").

This chapter advocates the adoption of specialized, administratively managed (nonjudicial) resolution regimes for Islamic banks, for the following reasons:[8]

- Insolvency regimes must mirror the unique features of Islamic banking; profit-sharing investment accounts are discussed as an example of those unique features.
- Early intervention and expeditious resolution at failure are necessary to protect consumers, maintain confidence in banks, and preserve the assets of failing or failed banks. These objectives would be best met through nimble, administratively managed processes rather than through the courts and subject to generic bankruptcy laws, particularly in jurisdictions in which the courts and/or insolvency laws are not suited for bank failures or where existing procedures might lead to ad hoc outcomes.[9]
- Islamic banking is, where Shari'ah compliance is concerned, effectively self-regulating, at both the firm and industry levels. Self-enforced Shari'ah compliance is appropriate given the relative youth of Islamic banking and the potential innovation benefits of laissez-faire approaches. But because Shari'ah shapes all aspects of Islamic banking, self-regulation must be tempered by robust process-based and outcome-driven regimes that disallow the monopolization of information to an extent that regulators are limited in their ability to obtain, process, validate, and act on information pertinent to the health of Islamic banks.

Importantly, the positions advanced in this chapter are premised on the view that defining legal outcomes through specialized insolvency regimes for Islamic banks will propel—as a matter of necessity—Islamic banks, standard-setting bodies, and regulators to improve existing Islamic banking regulation, with much needed policy direction and urgency.

Islamic Banking

Islamic banking has grown rapidly in the past 35 years,[10] reaching an estimated value of $1.1 trillion in 2012.[11] Since 2008, growth has accelerated even

8 This chapter is concerned only with Islamic banks, and not with Islamic windows of conventional banks.

9 In some jurisdictions, bank resolution can be ad hoc, even where the law provides for the regulation of banks by a single authority. For example, in the United Arab Emirates, "onshore" banks are supervised by the Central Bank. The Central Bank may appoint a liquidator and not itself liquidate insolvent banks (which are also subject to generally applicable insolvency laws). Such a framework does not ensure uniformity of outcomes. *See* United Arab Emirates Union Law No. 10 of 1980, *Concerning the Central Bank, the Monetary System, and Organization of Banking.*

10 Since shortly after the establishment of Dubai Islamic Bank in 1975. The first modern Islamic bank was Mit Ghamr, established in 1963 in Egypt. The establishment of Dubai Islamic Bank is used as a time marker here given the bank's comparatively large size, wider commercial banking mandate, and greater visibility.

11 Camilla Hall, *Islamic Banking: Impressive Growth Underscores Success*, Financial Times (Mar. 27, 2012), available at http://www.ft.com/cms/s/0/09a99422-7291-11e1-9be9-00144

faster. By some estimates, Islamic banking broke $1 trillion in 2009, from $947 billion in 2008.[12] "One potential scenario" predicts that "global Islamic banking assets with commercial banks . . . [will] reach $1.8 trillion in 2013 . . . representing average annual growth of 17%."[13] In the Middle East and North Africa, Islamic banking assets are projected to more than double to $990 billion by 2015, from $416 billion in 2010.[14] In Gulf Cooperation Council states, Islamic banks have "crossed the . . . important 25% [market share] threshold which means . . . [they] are competing in the conventional market as well."[15] At the firm level, it is expected that Islamic banks will take near-term steps to achieve scale through mergers and expansion.[16]

The growth of Islamic banks should be welcome. They have the potential to facilitate financial inclusion, including by meeting the needs of financially marginalized individuals and small and medium-size enterprises (SMEs) and capturing assets traditionally beyond the reach of formal economies. According to the World Bank, approximately "2.5 billion adults lack access to formal financial services, limiting their ability to benefit from economic opportunities, improve their health and education, and raise their income levels."[17] In the Middle East and North Africa, a natural market for Islamic banks, "only 18% of adults have a bank account."[18] In Egypt, the most populous Arab state, fewer than 10 percent of Egyptians have bank accounts, according to some estimates.[19] In Indonesia, the largest Muslim country by population, SMEs "are facing a credit crunch," notwithstanding the relative liquidity of Indonesia's commercial banks.[20] In other majority-Muslim jurisdictions, the market poten-

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feab49a.html#axzz2UKZvZVYt (accessed May 5, 2013). This is a conservative estimate. Ernst & Young, for example, estimates the 2011 value of global Islamic banking assets at $1.334 trillion. Ernst & Young, *World Islamic Banking Competitiveness Report 2013: Growing beyond DNA of Successful Transformation,* 6 (Dec. 2012), available at http://www.mifc.com/index.php?ch=151&pg=735&ac=818&bb=file1 (accessed May 3, 2013).

12 Pejman Abedfar, Philip Molyneux, & Amine Tarazi, *Risk in Islamic Banking* 2 (LAPE working paper, May 3, 2012). Cumulative estimates include both wholly Islamic banks and Islamic windows of conventional banks.

13 Ernst & Young, *supra* note 11, at 6.

14 Ernst & Young, *The World Islamic Banking Competitiveness Report*: *A Brave New World of Sustainable Growth 2011–2012* 8 available at http://www.ey.com/Publication/vwLUAssets/IBCR_Report/$FILE/IBCRReport2011(LR)%20Final.pdf (accessed May 3, 2013).

15 *Id.*, at 19.

16 *Id.*, at 66, 70.

17 World Bank, *Financial Inclusion: Helping Countries Meet the Needs of the Under-Banked and Under-Served*, available at http://www.worldbank.org/en/results/2013/04/02/financial-inclusion-helping-countries-meet-the-needs-of-the-underbanked-and-underserved (accessed May 3, 2013).

18 *Id.*

19 Business Today Egypt, *Payroll Potential*, available at http://www.businesstodayegypt.com/index.php?url=news/display/article/artId:39/payroll-potential/secId:3 (Jan. 1, 2011) (accessed May 3, 2013).

20 Jay K. Rosengard, *If the Banks Are Doing So Well, Why Can't I Get a Loan? Regulatory Constraints to Financial Inclusion in Indonesia* 1 (Kennedy Sch. of Govt., Mossavar-Rahmani Ctr. for Bus.

tial for Islamic banking is strong due to religion-based demand.[21] In minority-Muslim jurisdictions, regulators are keen to develop Islamic banking and finance to cater to small Muslim populations and to attract foreign funds.[22]

With the growth of Islamic banking and its potential comes the need for substantively appropriate regulation and effective enforcement. An International Monetary Fund (IMF) study on Islamic banks and financial stability found that "Islamic banks pose risks to the financial system that . . . differ from those posed by conventional banks . . . [due to] the specific features of Islamic contracts, and the overall legal, governance, and liquidity infrastructure of Islamic finance."[23] The same study concluded that large Islamic banks, compared to small Islamic and small and large conventional banks, were the least stable of the group.[24] "[L]arge Islamic banks . . . [had] significantly lower z-scores [a stability measure] than small Islamic banks," while large conventional banks were found to have "significantly higher z-scores than small commercial banks."[25] The growth of Islamic banks in number and size necessitates and underscores the importance of tailored regulation and insolvency frameworks.

& Govt. Working Paper No. 2011-15, Harv. U. 2011).

21 Some research has shown a preference among Muslim consumers for Islamic banking when it is available and perceived to be truly Shari'ah compliant. This sentiment was illustrated in an article about an Egyptian consumer who planned to transfer her savings to Islamic banks "after spending the last 15 years unwillingly investing her money in interest-bearing investment certificates . . . [and feeling that her profits were] never blessed." Sherine Abdel-Razek, *Flirting with Islamic Finance*, 1092, Al-Ahram Weekly (Apr. 5–11, 2012), available at http://weekly.ahram.org.eg/2012/1092/ec1.htm (hereinafter *Flirting with Islamic Finance*). The article reflects the preference of some Muslim consumers for Islamic banking, as well as their skepticism, noting the view of some Egyptians that "even Islamic banks in Egypt did not apply Sharia law completely."

22 For example, in South Africa, where 2 percent or less of the population is Muslim, authorities are working to position the country as an Islamic finance hub. Xola Potelwa, *S. Africa's FNB Hires New Sharia Committee, Faces Regulation Challenges*, Reuters (Apr. 30, 2013), available at http://www.reuters.com/article/2012/08/28/safrica-fnb-sharia-idAFL5E8JQ3OM20120828 (accessed May 3, 2013). Similarly, in Zambia, where approximately 12 percent (or less) of the population is Muslim, the country's central bank governor explained that Zambia's relatively small Muslim population includes "'high value businessmen who control a very significant share of the Zambian economy,' making their exclusion from the banking sector hurtful to the economy." Other Muslim-minority jurisdictions, such as the United Kingdom; Hong Kong SAR, China; and Singapore, have pursued Islamic finance with varying degrees of ambition.

23 Čihák & Hesse, *supra* note 6, at 4–5, countering the minority view that Islamic banking, as practiced, for example, in Malaysia, "is not very different from conventional banking . . . [and thus] for purposes of financial section analysis, Islamic banks should be treated similarly to their commercial [conventional] counterparts."

24 *Id.*, at 13–16 and generally. Finding also that Islamic banks—small and large—"appeared to be more stable than commercial banks . . . [a] result [that] seem[ed] driven by small Islamic banks that have higher z-scores than small commercial banks (indicating higher stability), while large Islamic banks have lower z-scores than large commercial banks." (*Id.*, at 13–14.)

25 *Id.*, at 14 & note 12, noting that these findings were at 1 percent. The authors indicate a positive correlation between "greater income diversity" (i.e., nonlending-based income) and increases in z-scores in large Islamic banks, "suggesting that a move from lending-based operation to other sources of income might improve stability in those banks." (*Id.*, at 17.)

Islamic Banks in Practice

Four of the bedrock principles of Shari'ah that shape Islamic banking are

- The prohibition of *riba*, a term commonly described as interest but that more broadly connotes the predetermination of fixed and guaranteed returns with elements of excessive risk asymmetry[26]
- Profit and loss sharing (PLS)
- The avoidance of *gharar;* that is, uncertainty to a degree that would obfuscate or frustrate economic or contractual purpose[27]
- The avoidance of speculation

As to the prohibition of interest, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has a standard on the conversion of banks from conventional to Islamic that is emphatic. That standard requires as a prerequisite of conversion that "[a]ll traces of conventional transactions whereby the bank originated monetary assets and is liable to pay interest for them must be liquidated."[28] The prohibition of interest—the primary measure of profit and marker for managing assets and liabilities in conventional banking—in principle distinguishes Islamic banks in all aspects of their operations.

Islamic Banking: Commercial Landscape

To compete with conventional counterparts, Islamic banks often benchmark profit margins to prevailing interest rates (e.g., Libor), both in extending credit and in sourcing funding through deposits. For example, *ijarah* (lease finance) and *murabaha* (cost-plus-profit sale-based financing) transactions (on the asset side of the banks' balance sheets) are typically benchmarked to interest rates. On the liability side of the balance sheet, Islamic banks raise funds through

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26 The concept of *riba* is well elucidated, as follows:

> *[R]iba*—a term literally meaning "an excess" and interpreted as "any justifiable increase of capital whether in loans or sales"—is the central tenet of the [Islamic] system . . . *riba* covers not only usury but also the charging of "interest" as widely practiced. This prohibition is based on arguments of social justice, equality, and property rights. Islamic law encourages the earning of profits but forbids the charging of interest because profits, determined ex post, symbolize successful entrepreneurship and creation of additional wealth, whereas interest, determined ex ante, is a cost that is accrued irrespective of the outcome of business operations. . . . Social justice demands that borrowers and lenders share rewards as well as losses . . . and that the process of accumulating and distributing wealth in the economy be fair and representative of true productivity.

Hennie Van Greuning & Zamir Iqbal, *Risk Analysis for Islamic Banks* 7 (International Bank for Reconstruction and Development/World Bank 2008).

27 AAOIFI, a key standard-setting body, defines *gharar* as "a state of uncertainty that exists when the process of concluding a transaction involves an unknown aspect . . . gharar refers to the status of results that may or may not materialize." AAOIFI, *Shari'a Standards for Islamic Financial Institutions,* Shari'a Standard No. (31), *Controls on Gharar in Financial Transactions*, para. 2/1 (Accounting and Auditing Organisation for Islamic Financial Institutions 1432H-2010) (entire compilation, hereinafter *AAOIFI Shari'a Standards).*

28 *AAOIFI Shari'a Standards*, *supra* note 27, Shari'a Standard No. (6), *Conversion of a Conventional Bank to an Islamic Bank*, para. 6/1.

PLS-based investment accounts (discussed below), which often are managed to achieve competitiveness with conventional interest-bearing deposit accounts.[29] Such practices have not gone without criticism. Both from within and outside the Islamic finance industry, Islamic banks have been accused of mimicking conventional products, rather than providing truly Shari'ah -compliant offerings. Critics often cite the practice of benchmarking profits to interest rates as proof. Some Muslim consumers are skeptical as to the authenticity of Islamic banking products and refrain from Islamic banking for that reason.

Legal Landscape: Gaps and Gray Zones

Most of the jurisdictions in which Islamic banks operate, including those in which Shari'ah is a source of law, have yet to adopt comprehensive legal frameworks tailored to Islamic banking. Where Islamic banking contracts have been litigated under civil law, results have been confusing and unhelpful to the extent that litigation has not yielded Shari'ah precedent.[30] Although standard-setting bodies such as AAOIFI and the Islamic Financial Services Board produce helpful frameworks, these frameworks are generally nonbinding and are not always timely.[31] As noted above, Islamic banks are largely self-regulating where Shari'ah compliance is concerned: substantive decisions as to the Shari'ah soundness of products and governance are made by Shari'ah supervisory boards that comprise Shari'ah scholars who are recruited and remunerated by the banks they supervise and whose decisions are often proprietary.

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29 *See*, for example, V. Sundararajan, *Profit Sharing Investment Accounts—Measurement and Control of Displaced Commercial Risk (DCR) in Islamic Finance*, 19(1) Islamic Econ. Studies, 42 (2011) (hereinafter Sundararajan 2011) noting commercial pressures on Islamic banks to provide "market related returns that might deviate from the underlying asset returns to which IAH are contractually entitled." In marketing *mudaraba*-based accounts, some Islamic banks indicate, but do not commit to, expected returns comparable to prevailing interest-based returns on functionally similar conventional products. Other observations on the likeness of Islamic and conventional banking are at, for example, Abedfar et al., *supra* note 12, at 10–11, discussing findings from Malaysia that "only 0.5% of Islamic bank finance is based on PLS principles"; from Pakistan, that *mudaraba* companies that "are supposed to operate in the form of PLS mainly follow non-PLS modes of finance"; from Indonesia, where "PLS modes of finance accounted for 35.7% in the financing of Islamic banks . . . by the end of 2008"; and, noting one interesting finding that "while Islamic banks appear to refrain from practicing PLS modes of finance they face possible greater withdrawal risks than conventional banks."

30 *See*, for example, Hdeel Abdelhady, *Islamic Law in Secular Courts (Again): Teachable Moments from the Journey*, 18 Intl. L. News (Fall 2009), discussing *Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Ltd*. (2004) All E.R. 1072; *Shamil Bank of Bahrain v. Beximco Pharmaceuticals Ltd*. (2003) All E.R. (Comm.) 849; Hdeel Abdelhady, *The Front Office Generates Revenue, the Back Office Creates Value: Operational Excellence Is the Key to Unlocking Lasting Value in Islamic Finance* (ABA & Hawkamah, the Inst. of Corp. Governance [DIFC] white paper). Both publications are available at http://www.masspointpllc.com/#!masspointnews-and-publications/c17jc (accessed May 3, 2013).

31 For example, AAOIFI's standard on the important subject of distribution of profit from PSIAs was issued in 2009, more than six years after AAOIFI's Shari'ah Board decided, in 2003, to issue a standard on the subject. *AAOIFI Shar'ia Standards*, Shari'a Standard No. (40), *Distribution of Profit in Mudarabah-Based Investment Accounts*, App. A: Historical Note on Preparation of Standard (hereinafter AAOIFI 40).

Such deficient and sometimes incongruous legal environments breed ambiguity as to the rights and obligations of Islamic banks and their counterparties, generally and at insolvency. The profit-sharing investment account (PSIA), a deposit product that yields no interest but is often managed to compete with interest-based deposits, is discussed here as an example of the issues that exist and can arise in jurisdictions lacking clear Islamic banking regulation and insolvency regimes.

PSIAs: A Unique "Liability" of Islamic Banks

Like their conventional counterparts, Islamic banks rely on customer deposits as a source of core funding. However, Islamic banks do not offer interest or other fixed, guaranteed returns on deposits (demand deposits[32] and others), but rather provide nonfinancial incentives to current account holders, such as bill payment, checkbooks, and debit cards.[33] Of interest here are PSIAs, which, from the consumer perspective, are functionally similar to, for example, conventional savings or certificate of deposit accounts.[34] Based on *mudaraba*,[35] PSIAs are of two kinds: "restricted" and "unrestricted."[36] They constitute a

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32 Current (or checking) accounts are known as *amanah* accounts. *Amanah*, an Arabic term, means, inter alia, "trust," and its definition includes "deposited in trust" and "a deposit." *The Hans Wehr Dictionary of Modern Written Arabic* 35, 36 (J. Milton Cowan ed., 4th ed., Spoken Language Services, Inc. 1994) (hereinafter *Wehr Dictionary*). From the Shari'ah perspective, Islamic banks are custodians of funds held in such accounts. Appropriately, an absolute reserve requirement attaches to *amanah* accounts.

33 *See,* for example, Rodney Wilson, *Legal, Regulatory and Governance Issues in Islamic Finance* 41 (Edinburgh U. Press 2012), discussing current account services offered by Dubai Islamic Bank.

34 *Mudaraba*-based Islamic banking accounts are referred to by some key regulators as PSIAs, a term that is used herein to refer only to *mudaraba*-based accounts. *See,* for example, Dubai Financial Services Authority (DFSA), *The DFSA's Islamic Finance Regulatory Regime*, available at http://www.dfsa.ae/Pages/DoingBusinesswithDFSA/IslamicFinance/IFRR.aspx (accessed May 2, 2012); and Bank Negara Malaysia, *Guidelines on Musharakah and Mudharabah Contracts for Islamic Banking Institutions*, available at http://www.bnm.gov.my/guidelines/01_banking/04_prudential_stds/15_mnm.pdf (accessed May 2, 2012). The DFSA is the regulator of financial (conventional and Islamic) and related activities in the Dubai International Financial Centre. Bank Negara Malaysia is Malaysia's central bank.

35 *Mudaraba* is a form of Islamic partnership between one or more providers of capital (*rab al-maal*, pl. *arbab al-maal*) and one or more parties providing labor or other services, such as investment management (the *mudarib*). *Mudaraba* generally and *mudaraba*-based bank products are discussed in *AAOIFI Shari'a Standards*, *supra* note 27, Shari'a Standard No. (13), *Mudaraba* (hereinafter AAOIFI 13), and AAOIFI 40, *supra* note 31. *Mudaraba*-based investments also appear on the asset side of Islamic banks' balance sheets (with the Islamic bank as capital provider and a third party as *mudarib*). Like PSIA holders, Islamic banks risk the loss of their capital in such arrangements, which raises separate but related regulatory and insolvency risk issues that are not discussed in this chapter.

36 Restricted *mudaraba* accounts typically are held by more sophisticated customers (e.g., in the High Net Worth bracket). Unlike unrestricted accounts, restricted *mudaraba* transactions are limited to certain investments (e.g., specific projects, industries) per the instruction of or agreement with the capital provider; thus bank discretion is limited. Importantly, restricted *mudaraba* accounts are not balance sheet liabilities for Islamic banks.

significant portion of Islamic banks' liabilities. By one estimate, more than 60 percent of Islamic banks' funding derives from PSIAs.[37]

PSIAs are generally available to all classes of customers, regardless of sophistication, and often with relatively small opening or minimum balance requirements.[38] Funds deposited are pooled with bank funds and invested by the bank at its discretion. Profits, if any, are distributed between the bank and PSIA depositors, according to pre-agreed-on percentages. Risk between the bank and PSIA depositors must be shared coextensively. According to AAO-IFI:

> It is not permissible for the capital provider to give the *mudarib* two amounts of capital on condition that the profit earned on one of the two amounts would be taken by the *mudarib* while the capital provider would take the profit earned on the other amount. It is not also permissible for the capital provider to state that the profit of one financial period would be taken by the *mudarib* and the capital provider would take the profit of the following financial period.[39] Similarly, it is not permissible to assign the profit from a particular transaction to the *mudarib* and the profit from another transaction to the capital provider.[40]

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37 Sundararajan 2011, *supra* note 29, at 42. "A survey of [a]nnual [r]eports of Islamic banks in different countries showed that about 62% of total assets of those banks were funded, on average, by profit sharing investment accounts." (*Id.*, at note 1.) *See* also V. Sundararajan, *Risk Measurement and Disclosure in Islamic Finance and the Implications of Profit Sharing Investment Accounts*, *Proceedings of 6th International Conference on Islamic Economics and Finance* 118 (Munawar Iqbal et al. eds., Islamic Development Bank 2007) (unrestricted *mudaraba* accounts represented "nearly zero to 80%" of the total deposits of some Islamic banks).

38 For example, Mashreq al Islami, the Islamic banking arm of Mashreq Bank, according to its website, requires an initial minimum deposit amount of AED 3,000 (roughly $816 per May 2013 exchange rates) to open a *mudaraba*-based "savings account," the mechanics of which are described on the website as follows:

> Under the Mudarabah (Fund management) arrangement, depositor (Rab Al-Mal) authorizes the bank (Mudareb) to invest the deposit according to the unrestricted Mudarabah. Funds of the term investment and Savings accounts are invested according to unrestricted Mudarabah basis in the joint investing pool between the depositors and the shareholders and the realized profits from the joint investment pool are distributed between the depositors according to their respective shares in investment.

Mashreq al Islami, *Personal Banking, Savings Accounts*, available at http://www.mashreqalislami.com/english/personal/accounts/savings-account/#faq-47573 (accessed May 4, 2013).

39 Interestingly, however, AAOIFI provides that "when loss is incurred in one *mudarabah* operation, it can be covered from the profits of other operations, and if it exceeds the profits it should be covered from capital. What should really matter is the final result of the liquidation at the end of the financial period specified by the institution." AAOIFI 40, *supra* note 31, at para. 3/2/1. *Shari'ah* merits aside, this allowance should come with explicit requirements for disclosures to PSIA depositors and regulators and policies for management and accounting.

40 AAOIFI 13, *supra* note 35, at para. 8/6. The Shari'ah requirement of coextensive risk is elemental. For example, in agricultural investment and sharecropping, the "Prophet [Muhammad (PBUH)] . . . prohibited speculative sharecropping arrangements, such as agreements giving parties rights to yields from specific tracts of agricultural land or specific produce from sharecropped land . . . [and] required that parties agree to apportion the total agricultural produce, whether in percentages or by other measures." Hdeel Abdelhady, *Islamic*

Owing to their nature and objectives, PSIAs have been likened to open-ended mutual funds and other collective investment schemes. But because they are offered by deposit-taking banks, regulatory classification of PSIAs varies. In the Dubai International Financial Centre, PSIAs are classified specially for regulatory purposes. In the United Kingdom, bank-offered PSIAs are treated as "deposits," a classification necessitated by the deposit-taking function of the offering bank but incompatible with the nature of the product.[41] AAOIFI describes PSIAs as "demand deposits" in one standard,[42] and likens the role of *mudarib* to an asset or fund manager in another standard.[43]

In theory, PSIA depositors bear the risk of loss of principal, except in cases of bank negligence, misconduct, or breach of contract. Therefore, no reserve requirement attaches to PSIAs.[44] In reality, however, Islamic banks engage in "return smoothing" to avoid depositor withdrawals in response to losses and to achieve parity with returns offered by conventional banks. They do this by various means, including

- Maintaining profit equalization reserve (PER) accounts and investment risk return (IRR) accounts, essentially rainy-day funds in which excess periodic profits are held to cover periodic profit shortfalls and capital losses[45]
- Forgoing, in favor of PSIA depositors, a portion of the bank's pre-agreed-on percentage of profits (as *mudarib*)

Finance as a Mechanism for Bolstering Food Security in the Middle East: Food Security Waqf, 13(1) Sustainable Dev. L. & Policy 29, 33 (2012), available at http://digitalcommons.wcl.american.edu/cgi/viewcontent.cgi?article=1524&context=sdlp (accessed June 11, 2013).

41 The Islamic Bank of Britain, for example, was required by the now-defunct Financial Services Authority to offer capital certainty to PSIA depositors as a condition of offering PSIA "deposit" accounts. To bridge the gap between Shari'ah and banking regulations, the Financial Services Authority and the Islamic Bank of Britain agreed to a two-step process whereby PSIA depositors were entitled, as a matter of law, to capital certainty at the time of account opening and thereafter could, by agreement with the Islamic Bank of Britain, forgo capital certainty. Andrew Henderson, *Islamic Financial Institutions*, in *Islamic Finance: Law and Practice* 54, 69 (Craig R. Nethercott & David M. Eisenberg eds., Oxford U. Press 2012). This two-step process, expedient on the front end, could lead to uncertainty in the absence of explicit, effective disclosure. For example, would depositors' waivers of capital certainty have been acceptable and effective only upon their having verifiably received and agreed to express disclosures as to the nature and consequences of such waivers? Would the waivers, particularly those given by retail customers, be enforceable against customers in the event of bank insolvency (thus foreclosing any claims to deposit insurance)? Even if yes, would or should public policy tolerate, or allow a repeat of, such an outcome, to the detriment of consumer confidence?

42 AAOIFI 40, *supra* note 31, at para. 2.

43 AAOIFI 13, *supra* note 35, at para. 9/4. This original Shari'ah standard on *mudaraba*, under the heading "Duties and Powers of the Mudarib," states that "the mudarib must carry out all the work that any similar asset or fund manager would be liable."

44 *See* Greuning & Iqbal, *supra* note 26, at 19–20.

45 PER and IRR accounts are employed to further a common objective, but their mechanics differ. Excess profits are reserved in PER accounts to cover future shortfalls in profit. Funds are reserved in IRR accounts to compensate for losses of principal.

- Deducting from profits owed to shareholders to bolster returns to PSIA depositors[46]

The transfer of profits from shareholders to PSIA depositors is known as *displaced commercial risk,* because the risk of loss is "displaced" to shareholders to maintain a competitive position.[47]

PSIAs raise a number of issues for Islamic bank insolvency and supervision, not only because of the risk of loss borne by depositors, but also because of the way these accounts are managed. The Dubai Financial Services Authority (DFSA) highlighted some of these issues in its comments to the G20 Financial Stability Board on effective insolvency regimes for SIFIs:

> The structures used in Islamic finance raise substantial questions [in insolvency] about depositor preference and deposit insurance. A common structure in Islamic banking is the . . . (PSIA), which in market terms plays a similar role to a conventional deposit account. It is in principle an investment product, in which both return and principal are at risk, but in practice, banks use various smoothing mechanisms to provide a return very similar to a conventional deposit and often mirroring conventional interest rates in the same market. Some regulators therefore follow the underlying principle, and treat PSIAs as investments; others treat them as deposits. Views in this area tend to be strongly held, and the situation is further complicated by the fact that there has been no legal test of this position in an insolvency.[48]

In addition to the classification of PSIA accounts, determinations of depositor preference, and rights to deposit insurance (where available), important questions about PSIA depositor treatment vis-à-vis Islamic banks, nondepositor creditors, and other PSIA depositors must be addressed.[49] For example, should less sophisticated PSIA depositors be treated more favorably than their more sophisticated counterparts? Retail consumer protection would require this result.[50] Should all PSIA holders be given low or no priority

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46 *See*, for example, Sundararajan 2011, *supra* note 29, at 48–49. In an extreme case, "the International Islamic Bank for Investment and Development in Egypt . . . distributed all of its profits to investment account holders and nothing to shareholders from the middle to late 1980s." Greuning & Iqbal, *supra* note 26, at 176–177.

47 Sundararajan 2011, *supra* note 29, at 48.

48 G20 Financial Stability Board, Press Release, *Comments Received on the FSB Consultative Document on Effective Resolutions of SIFIs, DFSA Draft Comment Letter to the FSB* (hereinafter *DFSA Comments*), available at http://www.financialstabilityboard.org/press/c_110909t.pdf (accessed May 3, 2013).

49 A rudimentary question is whether PSIA depositors are creditors at all, particularly in the absence of bank negligence, misconduct, or breach of contract (events that would trigger different kinds of claims and perhaps render them judgment creditors).

50 Consumer protection and the maintenance of market confidence would justify strict disclosure requirements and depositor priority preferences tied to the relative sophistication of PSIA holders, using, for example, proxy measures of "sophistication," such as the net worth or annual income criteria, applied to determine accredited investor status in the

because they assumed risk of loss? If so, are prevailing standards of disclosure sufficient to justify this outcome?[51] If yes, would the policy objectives of consumer protection and market confidence outweigh a contract-based assignment of responsibility at insolvency? In addition, there are insolvency-related issues relevant to return smoothing practices. For example, are PER and IRR accounts the property of the bank, or do PSIA holders have some claim to those funds in insolvency? If the latter is the case, how and in what percentages should PSIA depositor claims to PER and IRR accounts be fixed? More important, do regulators understand return smoothing and related accounting and distribution practices sufficiently to isolate claims to them in insolvency? At what point should the Islamic bank's profit for managing PSIAs be considered realized, and how does this factor into insolvency?[52] And do regulators have the information needed to determine if an insolvency is attributable to negligence or misconduct, which would trigger clear PSIA depositor claims? These are just some of the questions surrounding PSIAs in insolvency. Questions about the nature of Islamic banking and the classification and preference of claims in insolvency are numerous and have yet to be clearly answered or comprehensively identified.[53]

United States for purposes of allowing exemptions from registration requirements. See, for example, United States Securities & Exchange Commission, *Accredited Investors*, available at http://www.sec.gov/answers/accred.htm (accessed May 3, 2013).

51 Typically, parties that contract for the least risk (e.g., secured creditors) are accorded higher priority in bankruptcy. Shareholders, commensurate with their risk and presumed exertion of control, have low priority. In such creditor hierarchies, PSIA depositors occupy a legal no-man's-land because they share risk like shareholders but have no control and are treated as depositors but have no capital certainty.

52 Related to these questions are AAOIFI standards on the realization of distributable profits, including that "realization of profit in investment accounts does not take place before protecting the capital" (AAOIFI 40, *supra* note 31, at para. 3/1/1); "[r]ealization of profit in investment accounts does not take place before . . . [inter alia] [l]iquidation of *mudarabah* assets, which can be either actual liquidation . . . or legal liquidation" (*id*., at para. 3/1/2/1); "[i]t is permissible to pay advance amounts to the holders of accounts before actual or legal liquidations so that final settlement can be made later on [and] [a]fter actual or legal liquidation the institution is committed to make necessary additions to, or deductions from, the advanced amounts so that each holder of an investment account receives his exact share of the profit" (*id*., at para. 5/3). As these and other *mudaraba* standards make clear, attribution of entitlement to profit requires meticulous and transparent accounting and reporting that is very specific as to, inter alia, time and finality.

53 With respect to return smoothing, neither the size of PER and IRR accounts nor the internal policies governing their management are sufficiently clear. What checks are in place to ensure that PER and IRR accounts are properly used and accurately represented in regulatory disclosures, annual reports, and customer documentation? Publicly available information does not facilitate ready verification that PER and IRR funds are consistently managed and distributed in strict accordance with PSIA account documentation, articulated policies, and applicable standards. Could PER and IRR funds be appropriated for other purposes, such as to raise firm value or shareholder returns? One study of Islamic banks showed that "Islamic banks [generally] yield lower stock returns for their investors . . . but [yielded higher returns] during the crisis [period of Q4-2007 and Q4-2008]." Thorsten Beck, Asli Deirguc-Kunt, & Ouarda Merrouche, *Islamic vs. Conventional Banking: Business Model, Efficiency and Stability* 21 (World Bank Policy Research Working Paper No. 5446, World Bank 2010). These authors state that the "higher liquidity reserves and better capitalization [of Islamic banks] can explain the higher stock returns." But it is reasonable to question what, if any, role funds

Specialized Insolvency Regimes for Islamic Banks

Insolvency regimes for Islamic banks should reflect the nature of Islamic banking,[54] comport with Shari'ah insolvency rules, and further Shari'ah-based objectives for market regulation. In dual jurisdictions in which Islamic and conventional banks operate side by side, considerations of judicial economy are particularly relevant.[55] The design of resolution regimes should compensate for any general weaknesses of legal and regulatory infrastructure, such as the inexperience or inadequacy of courts or regulators to expeditiously manage bank insolvencies in the absence of specialized frameworks.

In designing insolvency regimes for Islamic banks, it is not sufficient to focus only on achieving convergence of Shari'ah and conventional insolvency rules. Shari'ah insolvency rules developed and applied in the context of single debtors, bilateral relationships, or relatively small groups are not, by themselves, sufficient to inform resolution regimes for Islamic banks. Rather, Shari'ah insolvency rules must be interpreted in accordance with, and further the objectives of, Islamic legal and historical views of market regulation, which require that regulators be empowered to ensure lawful market conduct, impose market discipline, promote transparency, and protect consumers. Similarly, it is insufficient to examine conventional insolvency regimes applicable only to banks, because Islamic banking encompasses banking and capital market activities. The remainder of this chapter focuses on some fundamental Shari'ah insolvency rules, the nature and objectives of Shari'ah market regulation, and an example from the United States of a substantively harmonized, administratively managed insolvency regime.

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reserved in PER and IRR accounts could play in such an atypical performance, particularly at times in which PSIA depositor expectations for returns might be low (such as during a financial crisis). Although it is accepted that Islamic banks were not directly exposed to losses incurred by conventional banks in the 2007–2008 period (an obvious explanation for the atypically better return to shareholders), it is also accepted that Islamic banks typically yield lower returns to shareholders. Such issues underscore the need for robust, uniform accounting rules and practices, meaningful reporting requirements, and effective disclosure. Without verifiable information, the conclusiveness of some empirical analyses of Islamic banks' performance (however measured) is open to doubt.

54 Regulators need to decide whether to tailor insolvency frameworks to Islamic banking as understood in theory or as practiced, where there is divergence. As indicated above, Islamic banking theory and practice are not always or reliably the same. Presumably, regulators prefer that Islamic banking be truly Islamic, to justify and promote competition with and to secure the benefits of Islamic banking. But regulations must be practical. This is yet another policy question that is crystallized by insolvency considerations.

55 The author is aware of only two wholly Islamic banking systems, one in Sudan and one in Iran.

Shari'ah View: Insolvency (*Taflīs*) and Regulatory Prerogative (*Hisba*)

Insolvency regimes for Islamic banks must conform to, or be compatible with, Shari'ah rules on bankruptcy (*taflīs*)[56] and Shari'ah generally. But the extraction of rules from one area of Shari'ah (bankruptcy) without consideration of other relevant areas (market conduct and regulation) is an approach that lacks policy direction. This section discusses some of the basic elements of Shari'ah insolvency and market regulation, which together should inform policy choices on matters such as depositor and other creditor priority in bankruptcy.

Shari'ah Foundational Principles on Insolvency

Shari'ah bankruptcy rules share common principles with what are regarded as modern insolvency rules. The rules of *taflīs* and varying opinions of classical Shari'ah scholars were articulated not long after the advent of Islam.[57] Islamic law recognizes insolvency as a legal status that triggers both creditor standing to bring claims and judicial authority to intervene in the financial affairs of debtors.[58] Classical Shari'ah jurists recognized both balance sheet and cash flow insolvency, and courts (judges) were authorized to "interdict" debtors (declaring the debtor insolvent as a matter of law) and prohibit the sale or other disposition of assets during the pendency of insolvency proceedings.[59] Shari'ah deals also with creditors' rights and respective priorities, but there are questions as to how those priorities would play out in contemporary practice. The DFSA has highlighted some of the issues:

> [W]e note that thinking about insolvency in the context of Shari'a law is at a relatively rudimentary level. . . . To give just one example, traditionally creditors are only those with matured debt, which clearly limits the ability of many who would normally be deemed creditors to take part in insolvency proceedings. One important feature of traditional Shari'a thinking is that all unsecured creditors rank *pari passu*, which clearly limits the ability to establish a hierarchy of claims. More work will therefore need to be done to consider

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56 The Arabic *taflīs* means bankruptcy or insolvency, or the "declaration of bankruptcy." *Wehr Dictionary*, *supra* note 32, at 850.

57 As evidenced by Ibn Rushd's writing discussed here, *infra* note 58.

58 Ibn Rushd, *The Distinguished Jurist's Primer*, vol. 2 (*Bidāyat al-Mujtahid wa Nihāyat al-Muqtahid*), *The Book of Taflīs (Insolvency; Bankruptcy),* 341–352 (Imran Ahsan Khan Nyazee trans., Garnet 2000) (hereinafter Ibn Rushd). Ibn Rushd, full name Abū al-Walīd Muhammad ibn Ahmad ibn Rushd, or Averöes, as he is referred to in Western literature, was a distinguished jurist and a judge (*qādī*) in Cordova. This work is a book on *khilāf* (Arabic term that, in this context, means different views or disagreement), that is, a "discipline that records and analyzes the differences among Muslim jurists." (*Id.,* at 33.) It is the equivalent of a modern treatise or restatement of law that catalogs majority and minority views on points of Islamic law. The purpose of the book was, in Ibn Rushd's words, "for guidance of the (would-be) *mujtahid* [jurist] in whatever he may encounter of the [legal] issues of this book." (*Id.*)

59 *Id.,* at 342–344. "The term *iflās* [bankruptcy], in the law . . . [has] two meanings. First, when the debts completely cover the assets of the debtor, and his wealth does not suffice to pay his debts. Second, when he does not have any known wealth at all." (*Id.,* at 341.)

> how effective resolution regimes can be implemented in countries where Shari'a law is a significant element of the legal system. There may also be instances in Islamic finance where Shari'a may be held to apply to particular transactions even within a common or civil law system.[60]

The DFSA is correct, except that more work is needed to do more than just "consider how effective resolution regimes can be implemented in countries where Shari'a law is a significant element of the legal system." More fundamentally, work is needed to fashion Shari'ah-compliant insolvency rules that reflect the reality that Islamic banks deal with the public and intermediate on a large scale. Shari'ah-based market regulation is instructive in this respect.

Shari'ah-Based Market Regulation: Hisba[61]

Islamic law and historical practice favor a strong role for regulators in setting binding standards of market conduct and carrying out market supervision. The Islamic framework of government includes the office of the market supervisor (*al Muhtasib*), the mandate of which is, broadly, "to promote good . . . and prohibit evil."[62] Bound by law and possessing delegated authority, the *Muhtasib's* function, like that of the modern regulator, is decidedly executive in nature.[63] The *Muhtasib's* powers are greatest in the areas of commerce and trade.[64] In the markets, the *Muhtasib* is duty-bound to promote transparency

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60 *DFSA Comments*, *supra* note 48. As to creditor priority, this interpretation is not entirely representative (and neglects Shari'ah views on market regulation, which should influence interpretations as to creditor priority and other matters). For example, Shari'ah accords higher priority, assuming certain conditions exist, to parties that have sold or financed property to a debtor but have yet to be paid in full at the time of the debtor's insolvency. For example, "If the corpus of the thing [the property] itself, because of which the creditor has a claim against the insolvent, has expired, the debt exists as a liability of the insolvent. If, however, the thing exists and has not expired, but the creditor did not take possession of the price (*thaman*) . . . [*some* jurists held that] the owner . . . has a prior right to it, unless he relinquishes it and participates in the liquidation." (*Id.*, at 341.)

61 *Hisba* derives from the Arabic root *hasb*, meaning, inter alia, "reckoning or opinion." Similarly, the terms *hisāb* (meaning, inter alia, "accounting") and *muhtasib* (meaning "accountant, bookkeeper, comptroller, auditor") share the same lineage. *Wehr Dictionary*, *supra* note 32, at 205–207.

62 Abū al-Hasan Al-Māwardi, *The Ordinances of Government (Al-Ahkām al-Sulhāniyya w' al-Wilāyāt al-Dīniyya)*, 260–280, 260 (Wafaa H. Wahba trans., Garnet 2000) (hereinafter, Al-Māwardi). "The market supervision, or public morals office . . . is an injunction to promote good if obviously forsaken, and prohibit evil if manifestly done. As God, exalt Him, says: 'Let there be among you a nation who invite the good, enjoin kindliness, and forbid indecency' " (citing the Qur'an 3:104).

63 *Id.*, at 260–280, discussing the role of the *Muhtasib* as an official office of the state in respect to both public morals and the regulation and supervision of commerce in the marketplace. *See* also Karen Stilt, *Islamic Law in Action: Authority, Discretion, and Everyday Experiences in Mamluk Egypt* (Oxford U. Press 2011), discussing historical accounts of the *Muhtasib* in Mamluk Egypt (hereinafter, Stilt). The role of the *Muhtasib* encompasses both the oversight and regulation of commercial activities and the oversight and regulation of public morals (related to such matters as public prayer). This chapter is concerned only with market regulation.

64 Al-Māwardi, *supra* note 62, at 262.

and market discipline, ensure lawful market conduct, maintain market confidence, and protect consumers[65] against unlawful and deceptive practices.[66] To achieve these ends, the *Muhtasib* is required to formulate rules based on practical knowledge of the marketplace.[67] According to one historical account of the *Muhtasib's* rule-making role during the Mamluk period in Egypt (1215–1517):

> For all of their detailed rules . . . the *fiqh* [i.e., law or jurisprudence] books did not offer much guidance on how the *muhtasib* should identify infractions and punish them. . . . A *muhtasib* needed to know the tricks [of the market] and how to identify them, and the [*Muhtasib's*] manuals gave very practical advice on how to detect fraud in the various trades. On a daily basis, the *muhtasib* himself added another layer of discretion in deciding how to approach the regulation of the markets."[68]

At the same time, the *Muhtasib*, consistent with the principle of freedom of contract in Islamic law, respected market participants' contracts, so long as their transactions were understood by them and not harmful to others (in contemporary practice, this position would support, for example, strict disclosure and the restriction of some products to sophisticated consumers).

This brief description of the *Muhtasib* indicates that the role of the regulator, from the Shari'ah perspective, is clear, requiring practical regulation, consumer protection, responsiveness to market realities, and respect for the rights of qualified parties to contract as they see fit. The approaches and objectives of Shari'ah market regulation should be reflected in insolvency regimes for Islamic banks.

Specialized Insolvency Regimes for Islamic Banks: Administrative Management and Substantive Hybridization

Because Islamic bank operations are complex in the sense that they encompass traditional banking and capital market activities, and because they offer sophisticated products to both sophisticated and unsophisticated customers, specialized regimes for their resolution should be multifaceted, with banking and capital market components and strong consumer protection objectives.[69]

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65 "Consumer protection was a core part of the *muhtasib*'s job." Stilt, *supra* note 63, at 127, explaining that in Mamluk Egypt, "the [*muhtasib's*] appointment decree from the sultan focuses almost exclusively on market-related behavior, indicating a strong interest in commercial transactions. From the sultan's perspective, ensuring that the markets were running smoothly was more than a concern for the average person's welfare."

66 Al-Māwardi, *supra* note 62, at 261–262.

67 *Id.*, at 279–280. "The market supervisor does not avoid reasoning based on customary practice, although he refrains from reasoning in jurisprudence." (*Id.*, at 279.)

68 Stilt, *supra* note 63, at 127.

69 Indeed, the post–financial crisis adoption of OLA is testament to the need for timely adoption of insolvency regimes that fit the realities of the market and financial firm operations. Arguably, revisions to U.S. bankruptcy laws and processes should have been made in tandem with or not long after the enactment of the Gramm Leach Bliley Act in 1999, a law that,

An instructive example of such a specialized, substantively harmonized, and administratively managed framework is the Orderly Liquidation Authority (OLA) regime under Dodd-Frank.[70] The multiparty and multidisciplinary process by which OLA was formulated is also instructive because the process of designing Islamic bank insolvency regimes should include Shari'ah experts, regulators, standard setters, and Islamic banks.[71] The remainder of this chapter discusses aspects of the OLA framework, with a focus on some of the powers of the FDIC as receiver (separately of deposit-taking banks and OLA-eligible financial companies) and the treatment of insolvent broker-dealers (also a part of the OLA framework).

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inter alia, repealed the "affiliation" sections of the Banking Act of 1933 (commonly known as the Glass-Steagall Act), and thereby removed the statutory wall separating banks, securities firms, and insurance companies in the United States and opening the door for their affiliation and competition. *See* Gramm-Leach-Blilely Act, Pub. L. No. 106-102, sec. 101, 113 Stat. 1338, 1341 (1999).

70 This chapter does not suggest that Islamic banks and OLA-eligible entities have the same operations or are exposed to or pose the same risks. It is important to note that orderly liquidation is a last resort option available only when it is determined that, inter alia, orderly liquidation is necessary to avoid damage to the financial system and protect public funds from bailout scenarios. Furthermore, OLA-eligible financial entities, particularly bank holding companies, conduct different business lines through subsidiaries. Islamic banks conduct traditional banking and capital market operations via a single entity, and such organizational differences have implications at resolution. Finally, it is worth noting that the OLA framework has not been unanimously embraced; for example, doubts have been raised about the FDIC's ability to orderly liquidate financial behemoths subject to OLA and the constitutionality of OLA itself. *See,* for example, Stephen J. Lubben, *The Flaws in the New Liquidation Authority,* N.Y. Times (April 18, 2012), available at http://dealbook.nytimes.com/2012/04/18/the-flaws-in-the-new-liquidation-authority (accessed May 5, 2013); United States House of Representatives Committee on Financial Services, *July 9, 2013, Subcommittee on Oversight and Investigations Hearing titled "Examining Constitutional Deficiencies and Legal Uncertainties in the Dodd Frank Act,"* available at http://financialservices.house.gov/uploadedfiles/070913_oi_memo.pdf (accessed July 9, 2013). Views on the merits of OLA in the U.S. context aside, the framework is instructive for Islamic bank insolvency design as a substantively harmonized, administratively managed resolution regime. And, in any case, the components of OLA discussed herein, for example, SIPA liquidation and FDIC resolution mechanisms, are instructive as stand-alone features of U.S. bankruptcy and resolution regimes.

71 *See,* for example, Board of Governors of the Federal Reserve System, *Study on the Resolution of Financial Companies under the Bankruptcy Code,* 1 (July 2011), explaining that Dodd-Frank required the board of governors of the Federal Reserve System, in consultation with the Administrative Office of the United States Courts, to conduct a study of various options for a resolution framework. Multiple federal agencies, such as the Securities and Exchange Commission and the Commodities Futures Trading Commission, which have exclusive or shared subject-matter authority over OLA-eligible entities, have a role in the rule-making and orderly liquidation process.

FDIC Resolution of Deposit-Taking Banks

The FDIC-administered resolution regime[72] provides for a number of mechanisms that aid in furthering three primary policy objectives:

- To maintain public confidence in banks and the financial system
- To preserve and, where practicable, maximize failed bank assets and liabilities by, for example, the transfer of liabilities and assets to a healthy institution (purchase and assumption) or by establishing a bridge bank
- To minimize the cost of resolution to deposit insurance funds[73]

In addition, in FDIC resolution, the FDIC has the power to repudiate contracts, disallow claims, and recover assets fraudulently transferred up to five years before or after its appointment as receiver.[74] Importantly, some of the FDIC's resolution powers (applicable in bank resolutions) are available, in modified form, in orderly liquidation.[75] These and other aspects of the FDIC resolution process are attractive for the relative flexibility they provide.[76]

In the case of Islamic banks, receivership powers similar to those of the FDIC, particularly the ability to repudiate contracts, transfer assets to healthy institutions, and establish bridge banks (or bridge frameworks), are important, particularly in cases in which Shari'ah bankruptcy rules might limit a failed or failing bank's ability to accelerate and recover against counterparties that are in default at or around the time of the bank's distress or insolvency.[77] The ability to transfer assets and liabilities to a healthy Islamic bank or to create a bridge bank is also important given the absence of (demand) deposit insur-

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72 The FDIC's role as receiver, and not as deposit insurer, is discussed in this chapter.

73 *See* Federal Deposit Insurance Corporation, *FDIC Resolutions Handbook* 81–88, available at http://www.fdic.gov/bank/historical/reshandbook/ (accessed May 3, 2013) (hereinafter *FDIC Resolutions Handbook*). Transfer by purchase and assumption (P&A) is the most used resolution method. *Id.*, at 82.

74 The FDIC's powers in some regards here are broader than those of a bankruptcy trustee under the Bankruptcy Code (judicially managed); for example, the FDIC may repudiate contracts without regard to type, but a bankruptcy trustee may repudiate only executory contracts. (*Id.*, at 67–83.)

75 In the OLA context, for example, the FDIC has the power to organize a "bridge financial company," the functional equivalent of a bridge bank. Dodd-Frank, Pub. L. No. 111-203, sec. 210(a)(1)(F) (codified at 12 U.S.C. sec. 5390(a)(1)(D)) (Lexis 2013).

76 Generally, a study of the U.S. experience in supervising and resolving banks is worth review, as it reveals lessons learned (even if not always heeded). As the FDIC has stated: "The . . . FDIC learned many lessons about resolving failing financial institutions as it managed the banking crisis of the 1980s and 1990s. The number of failing institutions, their varied businesses, and asset sizes afforded the FDIC a wide range of resolution experiences. Because the crisis lasted a long time, the FDIC had to conduct resolutions at all phases of various economic cycles." *FDIC Resolutions Handbook*, *supra* note 73, at 81.

77 In addition, prevailing Shari'ah interpretations prohibit the assessment and retention of monetary penalties for delinquency in payment (penalties may be assessed to impose discipline but may not be retained by Islamic banks, and thus must be allocated to charity or disgorged if reflected as income to a bank). Some Islamic banks use positive incentives, such as rebates, to encourage counterparty discipline. *See,* for example, Abedfar et al., *supra* note 12, at 11 & note 9.

ance in most relevant jurisdictions and to facilitate the transfer of restricted *mudaraba* accounts to other institutions.[78]

In addition to the affirmative powers of the FDIC in resolving deposit-taking institutions (and its similar powers in the OLA context), the FDIC, as a matter of case law and statute, has the authority to deem "improperly documented agreements" nonbinding on failed banks, an important tool for preserving assets and imposing market discipline.[79] In the Islamic banking context, imposition of market discipline through such authority would be particularly helpful in light of some of the suboptimal contracting practices that have become known.[80]

OLA and SIPA Broker-Dealer Insolvency

The orderly liquidation framework encompasses insolvency rules and procedures for failed broker-dealers, a relevant element because Islamic banks engage in intermediation functions similar to those of broker-dealers that provide full (trade and advisory) and limited (trade and incidental services only) brokerage services. Some Islamic banks provide investment advisory, placement, and incidental services in various jurisdictions, including in the capacity of a *mudarib* and *wakeel* (agent under a *wakala* [agency] agreement). To the extent that Islamic banks place client funds and provide advisory services, the treatment and disposition of some customer accounts (particularly unrestricted *mudaraba* and *wakala*) will be an issue in insolvency. In connection with this, the United States Securities Investor Protection Act (SIPA) is relevant to the extent that it provides for an insurance program that protects the customers of certain insolvent broker-dealers and a specialized bankruptcy procedure for broker-dealers.[81] In bankruptcy (only Chapter 7 liquidation is available to broker-dealers), the Securities Investor Protection Corporation (SIPC) is

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78 The insurability of PSIA deposits is questionable (risk is borne in principle by PSIA depositors), but some observers have advocated for insuring PSIA depositors in some fashion. As noted below, the SIPC's (privately funded) insurance fund for broker-dealers is an interesting model that might have relevance for Islamic banking where nondemand liabilities (i.e., PSIAs) are concerned. As to the ability of regulators to transfer liabilities and/or assets to healthy firms, regulators must have access to verifiable information about other firms in the market—this is yet another instance in which insolvency considerations highlight pre-insolvency regulatory matters that need attention.

79 This is a special defense of the FDIC to claims on a failed bank's assets. As the FDIC explains: "Like a bank regulator, the receiver must be able to rely upon the books and records of the failed financial institution to evaluate its assets and liabilities accurately . . . unless an agreement is properly documented in the institution's records, it cannot be enforced either in making a claim or defending against a claim by the receiver." *FDIC Resolutions Handbook*, *supra* note 73, at 74.

80 For a discussion of some representative cases, *see,* for example, Abdelhady, *Islamic Law in Secular Courts (Again)*, supra note 30; and Abdelhady, *The Front Office Generates Revenue, the Back Office Creates Value*, *supra* note 30.

81 The insurance fund, mandated by federal statute and maintained by the Securities Investor Protection Corporation (SIPC) (the SIPC fund) is available only to customers of insolvent SIPC members, who are required to contribute to the SIPC fund. 15 U.S.C.S. sec. 78ddd (2013).

authorized to intervene and initiate (with court approval) a SIPA liquidation.[82] In a SIPA liquidation, the trustee (SIPC or a court-appointed trustee) is required to deliver securities (name securities) to customers of the failed broker-dealer, to the extent practicable.[83] This feature of SIPA-based insolvency reflects two relevant objectives of the SIPA process: to promote continuity in market activity and to protect consumers. Both the SIPA and the SIPA-specific insolvency procedures for broker-dealers are worthy of consideration in the development of insolvency regimes for Islamic banks as a component of a harmonized resolution regime relevant to their capital market functions.

Conclusion

The story of the growth of Islamic finance and banking has been recounted many times, with good reason. In a relatively short period, Islamic banking has become an international industry, estimated to control more than $1 trillion in assets and with stellar growth projections. The potential of Islamic banks to contribute to economic and financial sector development and financial inclusion is well understood. But the full potential of Islamic banking will not be realized without adequate legal and regulatory support.

As Islamic banks continue to expand across borders and in size, the risks associated with Islamic banking will increase as a practicality of doing business. Islamic banking is too young to absorb the shocks of poorly managed bank failures. But it is sufficiently mature to be understood and effectively regulated, including in insolvency. Owing to the nature of Islamic banking and the need for streamlined, expeditious resolution of failed banks, an administratively managed insolvency regime that combines laws appropriate to Islamic banks' various lines of business is desirable. One model for such a substantively harmonized, administratively managed regime is the orderly liquidation framework in the United States. Regulators, Islamic banks, standard-setting bodies, and other interested parties are well advised to undertake a collaborative process to develop and implement an insolvency regime for Islamic banks now, rather than to bear the reputational and economic costs of poorly managed bank failures in the future.

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82 11 U.S.C. sec. 742 (2013).

83 11 U.S.C. sec. 78fff(1)(b)(1) (2013).

Today, no one doubts the importance of justice and the rule of law to development. Indeed, it is a topic that excites considerable discussion. But what exactly is the nature of the relationship between justice, the rule of law, and development? And how can such a relationship be harnessed to improve the lives of people around the world, sustainably?

Volume 5 of *The World Bank Legal Review* tackles these crucial questions head on. The 32 chapters by distinguished scholars and practitioners offer myriad ideas on the interrelation between development and the rule of law. They also present a plethora of practical lessons about translating insights into real-life outcomes. Foremost among those lessons is that sustainable development both demands and delivers opportunity, inclusion, and equity. Regulatory innovation can help people secure durable economic opportunities. Access to justice can be a pathway for social inclusion and greater citizen engagement. Legal empowerment can promote greater equity in the distribution and enjoyment of public goods.

As the international community reshapes its development agenda, this volume of *The World Bank Legal Review* reminds us that justice, when woven into sustainable development objectives and processes, can unlock endless opportunities.

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