Institute of Banking Studies Research >>

Develop the Formal Protection Frameworks and the Insolvency and Liquidation Systems for the Islamic Financial Institutions

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AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
AT1	Additional Tier-1
BCBS	Basel Committee on Banking Supervision
CARs	Capital Adequacy Requirements
CAR	Capital Adequacy Ratio
CMA	Capital Market Authority
CBK	Central Bank of Kuwait
CMT	Commodity *Murabaha*h Transaction
CIBAFI	General Council for Islamic Banks and Financial Institutions
CPIFR	Core Principles for effective Islamic Finance Regulation
CPIDIS	Core Principles for effective Islamic Deposit Insurance Systems
CoCos	Contingent Convertible bonds
CPDIS	Core Principles for effective Deposit Insurance Systems
DIS	Deposit Insurance Scheme
D-SIBs	Domestic Systemically Important Banks
DIFX	Dubai International Financial Exchange
FSB	Financial Stability Board
FSI	Financial Stability Institute
GCC	Gulf Cooperation Council
HQLA	High-Quality Liquid Assets
IADI	International Association of Deposit Insurers
IAIR	International Association of Insolvency Regulators
IAs	Investment Accounts
IAHs	Investment Account Holders
IAIS	International Association of Insurance Supervisors
ICP	Insurance Core Principles
IDB	Islamic Development Bank
IFIs	Islamic Financial Institutions
IFSB	Islamic Financial Services Board
IFSI	Islamic Financial Services Industry
IIFM	International Islamic Financial Market
IMF	International Monetary Fund
IIG	International Investment Group
IRTI	Islamic Research and Training Institute
IOSCO	International Organization of Securities Commissions
IPICM	Investor Protection in Islamic Capital Markets
IIFS	Institutions offering Islamic Financial Services
LOLR	Lender of Last Resort
LCR	Liquidity Coverage Ratio

NSFR	Net Stable Funding Ratio
OECD	Organization for Economic Co-operation and Development
PSIA	Profit Sharing Investment Accounts
RWA	Risk-Weighted Assets
RSAs	Regulatory and Supervisory Authorities
SPV	Special Purpose Vehicle
SLOLR	*Shari'ah* Compliant Lender of Last Resort
SDIS	*Shari'ah* compliant Deposit Insurance Scheme
TID	The Investment Dar
TO	*Takaful* Operator
UNCITRAL	United Nations Commission on International Trade Law

Executive Summary

The breadth and depth of the recent global financial crisis of 2007/2008 has given rise to crucial inquiries for the regulatory and supervisory authorities in terms of the robustness and soundness of the financial regulatory frameworks. The financial crisis highlighted significant regulatory lessons for policymakers in terms of the imperative need for a comprehensive crisis management framework and an effective financial safety net. This safety net has the potential to restore market confidence and enhance the resilience and stability of the financial and economic sectors. Besides, the International Monetary Fund (IMF) has recently indicated the integration of the Islamic Financial Services Industry (IFSI) into its financial sector assessments starting from the year 2020 with the objective of enhancing prudential regulation in the fast-growing sector. This supervisory decision stems from the fact that the Islamic finance sector has grown in size and become systemically integrated and may have implications with regards to the stability of the global financial sector.

With that being said, this study attempts to investigate the current status of the financial safety net of the IFSI. This safety net comprises of an effective insolvency and resolution regime, a lender of last resort facility, and a deposit insurance scheme. Furthermore, due to the integration of the IFSI into the global financial system, this paper reiterates the urgent need to establish a well-functioning *Shari'ah* compliant Deposit Insurance Scheme (SDIS) as well as a *Shari'ah* compliant Lender of Last Resort (SLOLR) facility. The main objective of the SDIS is to prevent a run on deposits. It should have a broader mandate and alternative measures in addition to its primary depositors' repayment function. The SLOLR on the other hand, plays a critical role in providing liquidity for illiquid yet solvent Islamic financial institutions (IFIs), particularly during liquidity distress periods. In the same pattern, the Islamic Development Bank (IDB), the Islamic Research and Training Institute (IRTI) and Islamic Financial Services Board (IFSB) have jointly put in place eight building blocks to enhance the soundness and safety of the IFSI. The fourth building block involves the development of a reliable crisis management system, an effective resolution framework and a robust financial safety net.

It is noteworthy that the IFSB and the International Association of Deposit Insurers (IADI) recently issued initiatives for the establishment of core principles for effective SDIS. This is with the aim to provide a benchmark to facilitate the implementation of an effective SDIS taking into consideration the specific features of the Islamic banking sector. In addition to an effective SDIS and SLOLR facility, it is of equal importance to put in place an adequate stakeholders' protection framework for IFIs covering the three main components of the Islamic financial sector; namely, the Islamic banking segment, the Islamic insurance segment, and the Islamic capital market segment.

The research reiterates the prudential and supervisory objectives of stress testing for IFIs covering the overall major risk categories including unique risks in the IFSI. The main objective of a stress test framework is the potentiality of evaluating the solvency of IFIs in terms of meeting the capital requirements, particularly during the reasonably severe financial and economic environments. From a regulatory perspective, stress testing can be used as an oversight tool that provides a regular assessment concerning the resilience and safety of the financial system. Ideally, the stress testing framework should combine both insolvency and liquidity risks in a single joint framework.

Moving forward, an effective and predictable insolvency and creditor rights regime would help facilitate the credit extension and enable private sector development. The availability of internationally recognized insolvency and creditors' rights regimes can serve as a benchmark for international framework in the development of insolvency regimes at the domestic level. As for the establishment of insolvency regimes for IFIs, and there are a range of issues and challenges worthy to be discussed. Nonetheless, it is apparent that the proper approach to address these issues and help design such *Shari'ah* based insolvency and liquidation regimes is to adopt the internationally recognized regimes while maintaining the specificities of Islamic finance.

Section 1: The current status of financial safety nets in the Islamic financial sector

1.1 The role of Deposit Insurance Scheme (DIS) and Lender of Last Resort mechanisms (LOLR) in banking failure management.
1.2 The *Shari'ah* compliant Deposit Insurance Scheme (SDIS) as a driving catalyst to Islamic financial stability.
1.3 The implementation of a *Shari'ah* Lender of Last Resort (SLOLR) in preserving the soundness of the Islamic Financial Services Industry (IFSI).

1.1 The role of (DIS) and (LOLR) mechanisms in banking failure management

The main objective of orderly management of a bank's failure is to provide protection to its depositors and to preserve their timely access to their funds, which means reducing the risk of a run on the bank. However, due to insufficient available resources within the failed or failing bank, this objective is unlikely to be achieved without recourse to public funds, which may add a burden to the taxpayers and create an environment of moral hazard and conflict of interest.

1.1.1 DIS as an important component in the financial safety net

The financial safety net can be defined as incorporating aggregated functions of prudential regulation and supervision framework, a robust insolvency and resolution regime, LOLR and DIS.[1] The DIS plays a crucial role in the process of banking failure management. The fundamental usage of the deposit insurance fund is to pay out insured depositors in the case of a bank failure. This payout procedure has the ability to enhance depositors' confidence, limit the risk of a run on deposits, panic deposit withdrawals and contagion among banks. It ensures the stability of both the financial and economic sectors. The recent global financial crisis highlighted significant regulatory lessons for policymakers with regards to the importance of a well-established deposit insurance system. The evolution of the crisis undoubtedly illustrated the key function of the deposit insurance framework, irrespective of the protection form (full or limited protection) in maintaining both depositor confidence and stability within the financial system.[2]

Furthermore, a deposit insurance scheme, especially with a limited coverage, can partially reduce the cost related to the resolution and liquidation process of a failed financial institution. Therefore, it provides a financial relief for taxpayers and improves public confidence. A sound deposit insurance function needs to be an embedded part of a comprehensive financial safety net composed primarily of a prudential regulatory and supervision system. Moreover, it should entail effective and enforceable laws and legal frameworks, as well as a well-developed accounting and disclosure regime. Besides, regulatory and supervisory authorities shall review on a regular basis and strengthen their deposit insurance arrangements by implementing an international set of core principles where needed for effective deposit insurance as a benchmark.[3]

During the evolution of the global financial crisis 2008, a joint working group has been initiated between the Basel Committee on Banking Supervision (BCBS) and the (IADI) with the objective of establishing an international set of core principles for an effective deposit insurance system (CPDIS). These set of principles can be deemed as a conceptual framework and a set of best practices for an effective deposit insurance scheme. Domestic regulatory authorities, however, can put additional measures in their discretion to achieve effective DIS within their respective jurisdictions.[4] In addition to the payout process in cases of bank failure, DIS may also achieve the objective of depositors' protection by extending its funds to support other measures as an alternative to payout and liquidation. Such alternative measures have the potential to reduce the overall cost and provide a range of options for the management in the event of a bank failure.[5] The Financial Stability Board (FSB) within its revised "Key Attributes of Effective Resolution Regimes for Financial Institutions" requires jurisdictions to have a DIS in place as an external fund to facilitate the resolution of a financial institution.[6]

Accordingly, IADI's CPDIS states that the deposit insurance fund could be utilized for the resolution of a member institution. This resolution process, which includes, but is not limited to, transfer of assets and liabilities of the failing institution as well as the establishment of a bridge institution.[7] In early 2019, a joint survey was conducted by the Financial Stability Institute (FSI) and IADI with the aim of investigating the purpose of utilizing DIS's funds. The survey's outcome showed that more than half of the deposit insurers' members can use their resources in the form of capital or liquidity supports in assisting an acquiring bank for the transfer of assets and liabilities of a stressed member bank, prior to its insolvency, in order to prevent its failure and liquidation.[8]

In many jurisdictions, the DIS mandate is broader and includes a direct role in the bank failure management both as liquidator as well as resolution authority. These set of roles are necessary to protect deposits as well as to reduce the cost to the deposit insurance funds while maximizing the creditors' value.[9] Today, the existing DIS around the globe have become more substantial whereby uninsured liability holders might obtain an insurance coverage from the DIS funds.[10] On the contrary, almost all deposit insurance schemes in the MENA region have mandates limited to depositors' reimbursements. While only a few of them have an effective role in resolution procedures and might extend their funds to failing banks for non-liquidation options.[11]

It is worth noting that, within the rapidly developing fintech ecosystem, DIS need to maintain a level of flexibility to keep up with the emerging technologies in the financial sector. This is taking into consideration the possibility that a loss of trust in the fintech sector might trigger a contagion effect within the banking sector eventually undermining confidence in all forms of deposits.[12]

1.1.2 The LOLR facility as a second integrated part in a comprehensive financial safety net

Central banks can be deemed as liquidity re-insurers. They play a critical regulatory role in providing liquidity support to the banking sector, which in turn, ensures liquidity to the rest of the economy.[13] The LOLR mechanism helps banks' short-term creditors to be less inclined toward a panic withdrawal. Moreover, even if there is any sort of creditor run, the central bank's liquidity provision in the form of a LOLR has the capacity to prevent the need for a forced sale which otherwise would cause significant impairments to the value of the bank's assets, causing an unavoidable insolvency situation.[14]

The LOLR also helps maintain stability of the financial sector by preventing contagion among banks and financial institutions. This contagion could primarily arise from the increasing forced sale of similar assets held by the insolvent institution, which causes significant impairments in the value of portfolios held by otherwise solvent institutions. The continuous decrease in asset values can drive sound and viable institutions into insolvency.[15] In many jurisdictions, it is indicated that there is a lack of orderly and effective resolution regimes, whereby the failure of a stressed bank might threaten the stability of the financial sector. This fact may lead the central bank to provide liquidity support in the form of LOLR facility to insolvent institutions that have a viable business and would be recovered within a short-term frame with a reasonable level of certainty.[16]

In addition, central banks have faced challenges pertaining to the banks receiving LOLR facility but then deteriorating in their solvency positions. Fortunately, the current regulatory practice requires LOLR receiving banks to successfully pass a forthcoming solvency stress test. Central banks should then withdraw and terminate their liquidity support and put the stressed institution into resolution. As such, there will be a sound incentive for institutions seeking LOLR facility to efficiently use the time provided within the granted LOLR framework to rectify their problems. On the other hand, central banks might grant LOLR facility to an insolvent institution that has gone into resolution procedures. This liquidity facility shall be introduced for the purpose of restructuring and reorganizing a troubled yet viable business. Thus, LOLR facility provision can be a powerful and beneficial tool for an orderly insolvency and resolution regime.[17]

Current central banks' regulatory and supervisory practices require the establishment of an internationally agreed set of core principles for a modern LOLR facility. Among these sets of principles, it is important to put in place a well-designed solvency assessment and stress test framework. Another core principle is to clearly state how and in what circumstances does an institution restored back to its solvency status through resolution can obtain LOLR liquidity facility from the central bank.[18] Central banks provide liquidity support only to solvent and viable banks, though making a practical distinction between insolvency and illiquidity becomes more difficult, if not impossible during a financial crisis.[19] In addition, despite a bank's assets being worth less than its liabilities at a forced sale price, the institution could be deemed solvent from a going concern perspective if a liquidity default can be prevented.[20]

The period following on from the financial crisis witnessed an emerging trend among central banks to reduce the incentive of liquidity support and LOLR facility provision in dealing with distressed banks. Instead, moving towards what is known as a bail-in of bank creditors and depositors. Bail-in, which is a recently innovated and implemented risk sharing and absorbing technique for allocating some losses incurred by a distressed bank during a financial crisis to its depositors and creditors such as bond holders. Such instruments play a very important role in providing financial relief to the taxpayers and substantially reduce the potential public costs of a severe financial and banking sector crisis. Similarly, the risk and loss sharing nature of Islamic finance products has the potential to facilitate a bail-in of stakeholders during a bank resolution procedure (for example, Investment Account Holders (IAHs) who bear losses on their investments).[21] This post-crisis innovative technique has its presence in Islamic finance since its inception in the form of profit and risk sharing as we will see in the upcoming sections.

1.2 The SDIS as a driving catalyst to the Islamic financial stability

Over the past few decades, the (IFSI) has been witnessing double-digit growth. This constant growth has been all across the world and not merely limited to Islamic jurisdictions. This developing trend emerged after the recent global financial crisis of 2007. This trend also includes the perception that Islamic banking and finance can be a viable alternative or at least a complementary component to the conventional financial system to help regain the stability of the global financial sector. This development raised the call to the need of the establishment of a robust financial safety net for the Islamic finance system including a well-designed Islamic Deposit Insurance System that is in accordance with Islamic principles.

1.2.1 Size and the Systemic importance of the IFSI

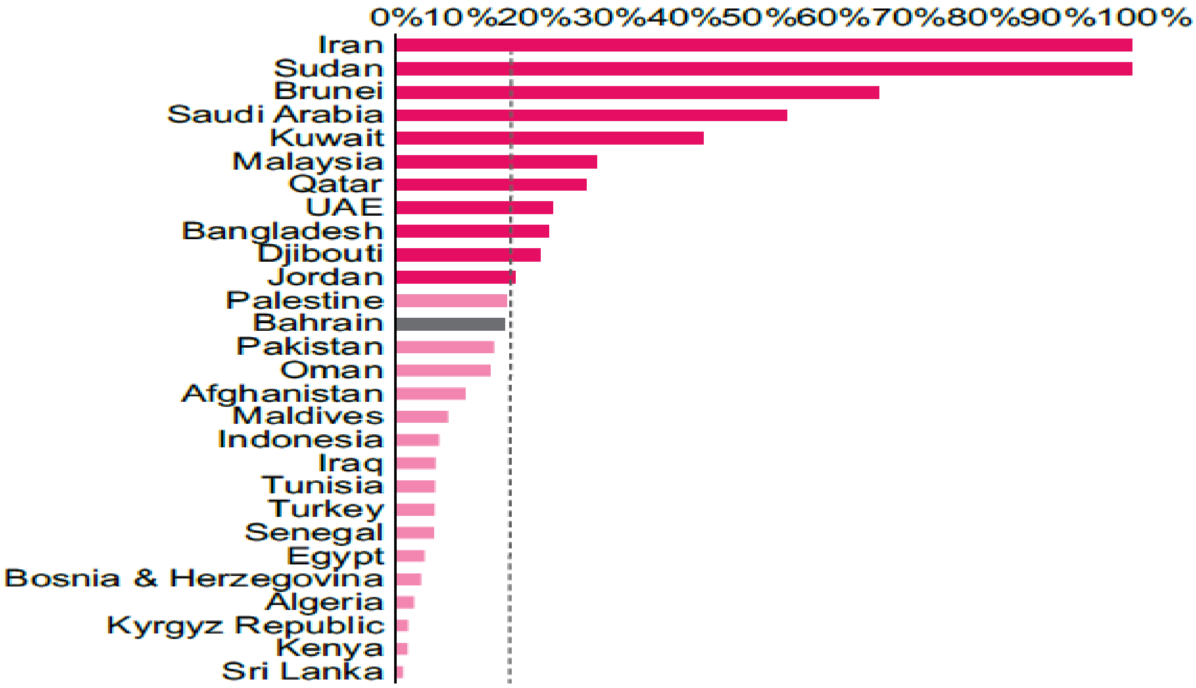
The IMF has recently indicated the integration of Islamic finance into its financial sector assessments starting from the year 2020, with the objective of enhancing prudential regulation in the fast-growing sector.[22] This supervisory decision stems from the fact that the Islamic finance sector has become systemically integrated and could have implications with regard to the stability of the global financial sector.

In 2018, the total assets of the IFSI achieved a third consecutive year of growth. The aggregated total assets of the three major sectors (namely the Islamic banking sector, takaful and the Islamic capital market) comprising the IFSI is estimated at USD 2.19 trillion as of 2018, compared to USD 2.05 trillion at the end of 2017, which is a USD 0.15 trillion increase from 2017 to 2018.

The IFSI is largely dominated by the Islamic banking sector in terms of the share of the assets. The Islamic banking sector's share was indicated to reach 72% of the total IFSI assets in 2018. Furthermore, among the countries in which the Islamic banks operate, 12 of these countries are considered to have a systemically important Islamic banking sector. Almost all of the 12 countries recorded a growing share of Islamic banking assets in relation to the total banking sector assets.[23] Kuwait is among the systemically important jurisdictions where the growth in the Islamic banking market reached 40.6% in relation to its total banking assets with an increase of 1.3% as compared to 39.3% in 2017.[24]

The chart below illustrates the asset share growth of the Islamic banking sector in relation to the total banking sector in 36 jurisdictions.

Chart (1) Islamic Banking Share in Total Banking Assets by Jurisdiction (2Q18)



Source: IFSB, Financial Stability Report 2019

Countries in dark red bars are categorized as systemically important as they satisfy the required criteria of having more than 15% Islamic banking assets share in relation to its total domestic banking sector assets.[25]

From the above illustration, it is apparent that at least 11 jurisdictions are currently categorized as systemically important. Therefore, they hold potential relevance for the systemic stability of both their local banking sectors as well as the global Islamic banking industry. Based on that and from a prudential regulatory perspective, it is paramount to develop a well-designed *Shari'ah* compliant financial safety net (comprising of but not limited to SDIS and SLOLR facility) in order to prevent any potential Islamic banking failure or systemic crisis.

1.2.2 The practice of the *Shari'ah* Compliant Deposit Insurance Scheme (SDIS)

In April 2010, the report entitled "Islamic Finance and Global Financial Stability" was a joint initiative of the IFSB, the IRTI and the IDB. The report distinguishes eight building blocks attempting to promote a resilient IFSI and enhance the Islamic financial infrastructure. The third building block in this report is related to the establishment of the financial safety net which includes among other components such as the SDIS as well as the SLOLR facility.[26] Similarly, the IMF also highlighted the issue of the availability of well-designed *Shari'ah* compliant financial safety tools which take into account the unique features of Islamic finance principles.[27]

Before discussing the practice of SDIS, it is essential to firstly have a brief about insurance both from conceptual and contractual perspectives. It is crucial at this point to differentiate between insurance as a system and insurance as a contract. As a system, insurance is pivotal for social and economic growth. It provides financial security and protection to the policy holders (both individuals and corporates). These policy holders would be, otherwise, financially incapable of bearing the covered losses without the assistance of insurance.

Despite fulfilling the noble objective of providing financial protection and coverage, which is among the *Shari'ah* objectives, conventional insurance suffers from fundamental and contractual issues in terms of its *Shari'ah* compliance. Conventional insurance is an exchange contract whereby premium payments now are exchanged for future compensations of specified loss events. Such an exchange contract would not be valid under *Shari'ah* law due to the *Gharar* (uncertainty or unknown outcome) element of the value or the occurrence of the covered losses. In this regard, The Council of the Islamic *Fiqh* Academy, during its second session (December 1985) and after having a look into what has been issued by the *Fiqh* academies, resolved that conventional insurance contains major elements of deceit, which void the contract and, therefore is prohibited according to *Shari'ah*[28].

On the contrary, *Takaful* (Islamic insurance) is a donation contract based on the concept of mutual indemnity to the payment of defined losses among the participants. Islamic insurance, therefore, shares the concept of mutuality and cooperation with the conventional cooperative insurance. Although *Gharar* still exists in Islamic insurance contracts, it has no impact and therefore, is tolerated in donation contracts according to *Shari'ah* law[29]. Furthermore, the permissibility of insurance as a system can be derived from the consensus permissibly of cooperative insurance among Islamic *Fiqh* academies as well as *Shari'ah* scholars.

From a *Shari'ah* perspective, the DIS objective of promoting financial stability and protecting depositors' rights is in line with *Shari'ah* principles. This underlying objective can be categorized under *Hifz al mal* (preservation of wealth), which is one of the *Maqasid al-Shari'ah* (*Shari'ah* Objectives).[30] Hence, in addition to the integration of the Islamic finance sector to the overall financial system, this analogy could justify the need for SDIS available to different Islamic banks' depositors.

Furthermore, SDIS can help Islamic deposits stay competitive against its conventional peers. By doing that, it can curb for any potential outflow of Islamic deposits from Islamic banks to conventional banks and help boost the growth of the Islamic financial system.[31] Additionally, SDIS can provide protection to Profit Sharing Investment Accounts (PSIA), which represents a material proportion of total Islamic deposits as opposed to conventional DIS, which may not be able or willing to do so. As a result, it will help create a level playing field not only between the Islamic and conventional deposit products but will also contribute to the stability and growth of Islamic financial sector.[32]

The following table shows a list of jurisdictions that provide SDIS to their Islamic deposits[33].

Table (1) List of jurisdictions providing SDIS

No	Country	Organization	Year of establishment
1	Bahrain	Central bank of Bahrain	1993
2	Bosnia and Herzegovina	Deposit Insurance Agency	2002
3	Indonesia	Indonesia Deposit Insurance Corporation	2005
4	Jordan	Jordan Deposit Insurance Corporation	2000
5	Kuwait	Central Bank of Kuwait	2008
6	Malaysia	Malaysia Deposit Insurance Corporation	2005
7	Singapore	Singapore Deposit Insurance Corporation	2006
8	Sudan	Bank Deposit Security Fund	1996
9	Turkey	Saving Deposit Insurance Fund	2005
10	United Kingdom	Financial Services Compensation Scheme	2001

Source: IADI-Survey on Islamic Deposit Insurance

The need for SDIS and its permissible objective from a *Shari'ah* standpoint has paved the path for the prerequisite of developing a set of core principles of such a scheme. In that matter, the IFSB and the IADI agreed to collaborate and come up with a set of core principles for effective Islamic deposit insurance systems (CPIDIS). The CPIDIS endeavors to provide Islamic finance jurisdictions with a benchmark for assessing the compliance and quality of their Islamic deposit insurance systems. Essentially, the CPIDIS envisages fostering sound integration of Islamic deposit insurance systems with the international financial infrastructure for financial stability.[34] In summary, most CPIDIS share similarity with the CPDIS issued previously by IADI with special emphasis on fulfilling the *Shari'ah* rules and principles.[35] It also highlights putting in place a comprehensive *Shari'ah* governance system.[36] It is worth noting that there is unanimous agreement among international financial authorities and standard-setting organizations including the IMF, IFSB and IADI on a range of issues and challenges facing the implementation and development of SDIS. From a regulatory aspect, there is no clear cut rule in many jurisdictions regarding the enforceability and sufficiency of the SDIS legal and regulatory framework.[37]

From a *Shari'ah* perspective, the provision of an insurance protection to the (IAHs) raises a *Shari'ah* permissibility concern due to the risk-sharing nature of the underlying contracts. Therefore, there is an argument between the proponents and opponents of such a protection scheme. Additionally, the proponents argue that such protection can be deemed permissible if it is provided by a third party (e.g. the SDIS) and IAHs are only reimbursed in the event of an Islamic bank's failure.[38] Similarly, both IADI and IFSB are of the view that Islamic deposit coverage for IAHs is possible, provided the mechanism is *Shari'ah* compliant.[39]

Another aspect of the above-mentioned issue is the priority and classifications of claims among the different types of Islamic deposits. While under a conventional DIS, all depositors are equally ranked, which is not necessarily the case under an SDIS, especially in regard to the IAHs for both restricted and unrestricted account holders. This priority ranking may eventually restrain the attractiveness of Islamic deposits.[40]

1.3 The implementation of SLOLR in preserving the soundness of the IFSI

The central banks' LOLR facility represents one of the most commonly used financial safety nets during liquidity distressed periods. This liquidity support, which is often granted against sufficient collateral, allows temporary illiquid but solvent financial institutions to solve their liquidity problems in a cost-efficient manner preventing a liquidity default without recourse to a forced asset sale. If this forced sale happens, it might result in a depositor run which may eventually threaten the stability of the financial sector.

1.3.1 The background of SLOLR facility

The underlying mechanism of a conventional LOLR facility is often based on interest bearing loans or security instruments, although it is prohibited for Islamic financial institutions to use such liquidity facility. With that being said, it is mandatory to consider appropriate SLOLR mechanisms for Islamic banks to manage their liquidity concerns. Furthermore, as an international prudential regulatory standards-setting body, the IFSB has regularly issued documents with respect to liquidity support and the role of SLOLR. The first issued document was the technical note titled, "Issues in Strengthening Liquidity Management of Institutions offering Islamic Financial Services (IIFS)" in 2008. The technical note emphasized the absence of transparent SLOLR facilities in a number of Islamic finance jurisdictions.[41] In the following released document, IFSB 12 "Guiding Principles on Liquidity Risk Management for IIFS" (2012), the board shed light on the task of supervisory authorities towards providing a greater clarity of their roles as the provider of SLOLR to the Islamic financial institutions. In achieving this objective, supervisory authorities should seek to expand the spectrum of *Shari'ah* compliant collateral issued in other jurisdictions as well as other currencies.[42] In 2015, the IFSB reiterated the mandatory establishment of an appropriate level of systemic protection comprised primarily of SLOLR and SDIS mechanism. This was to maintain confidence and stability within the financial system.[43]Subsequently, the most recent IFSB guiding note document highlights the measure that should be taken into consideration in SLOLR extended in a dual banking system. The SLOLR facility should then be able to operate alongside conventional LOLR facility with limited scope for arbitrage, especially for financial institutions that can use either of the liquidity facilities. This will stipulate similar profit rates, collateral requirements, tenors and other terms and conditions.[44]

The ultimate objective of the provision of LOLR facility is to protect troubled banks from an unavoidable failure or insolvency. It is viewed that such a liquidity facility is in compliance with the general *Shari'ah* rulings and principles. Additionally, the absence or denial of such liquidity provision will not only lead to the failure of the troubled bank but also cause a contagion effect among the entire banking sector, which may subsequently jeopardize the overall stability of the financial and economic sectors.[45]

1.3.2 The practice of *Shari'ah* contractual structure of SLOLR

While the economic substance of SLOLR facility does not differ much from its conventional peer, the economic form of it requires that the arrangement of the liquidity facility must be *Shari'ah* compliant. This enforces central banks of Islamic finance jurisdictions to have a range of *Shari'ah* compliant contracts to enable the SLOLR structure to be in line with

Shari'ah rulings and principles.[46] In the conventional LOLR practices, central banks extend their liquidity facilities to troubled banks using a range of mechanisms. The most important among them are: (i) Direct lending, which is the preferred mechanism. This mechanism carries relatively high rates and requires adequate and high-quality collaterals from the borrowing bank to document the loan. (ii) Repurchase agreements (repo), which is a combination of two binding and interdependent contracts in a single agreement. The first contract includes the spot sale of financial securities while the second contract combines with a deferred repurchase of the same securities by the seller at a price higher than the sale price. The difference in price therein forms the interest rate on the loan and is referred to as the repo rate.[47]

With *Shari'ah* product structuring in view, the issue in the first method is the fact that they are straightforward interest-bearing loans and are explicitly prohibited whilst the issue in the second repo method is less severe than the interest-bearing loans, especially since the underlying subject matter is the shares that are permissible rather than conventional bonds. However, the issues of a binding future sale transaction and purchase of the subject matter on a contractual condition remains controversial.[48] Having briefly elaborated on the issues related to the SLOLR structure, it is noteworthy that there exists a number of alternative mechanisms and Islamic contracts to develop an appropriate SLOLR facility. Therefore, central banks can implement diverse *Shari'ah* compliant mechanisms to extend SLOLR facility. The most common among them are (i) *Qard Hasan* or interest free loan mechanism, (ii) Commodity *Murabaha*h Transaction (CMT) mechanism, (iii) profit and loss sharing mechanisms including *Mudarabah* and *Musharakah*, (iv) investment agency *(Wakalah bi al-istithmar*) mechanism; and (v) Islamic repurchase agreements (Islamic repos) mechanism.[49]

Accordingly, the repo mechanism is a frequently used tool by central banks to conduct their function as the lender of last resort. This arrangement can be modified to take the form of a bilateral binding promise between the two contracting parties instead of a biding future contract, thus making it an eligible and straightforward SLOLR mechanism.[50]

In summary, this section has attempted to provide a conceptual framework for the current status of the Islamic financial safety net vis-a-vis its conventional peer. Furthermore, it takes into account the prevalence of the Islamic banking sector in IFSI. It also observed a need to provide a comprehensive protection framework to Islamic finance stakeholders while incorporating other sectors of the IFSI (namely the Islamic capital market and the Islamic insurance sector) in addition to the Islamic banking protection framework such as SDIS and SLOLR. By doing so, there will be a greater assurance of the overall resilience and soundness of the IFSI, particularly after its inclusion within the financial assessment of the global financial system.

Section 2: Developing a comprehensive solvency and stakeholders protection frameworks for IFIs

2.1 Solvency and Capital Adequacy Requirements (CARs) for both Islamic banking and non-banking institutions: Basel Accords and IFSB prudential guiding standards.
2.2 An analysis of Basel III compliant *Sukuk* (case for Kuwaiti Islamic Banks)
2.3 Stress testing for major risk categories.
2.4 Conducting a solvency stress test as per IFSB-13 guiding principles.
2.5 Designing a stress testing system for IFIs (Joint Stress Testing of Solvency and Liquidity).

2.6 Protection framework for IFIs

2.1 Solvency and CARs for Islamic banking and non-banking institutions: Basel Accords and IFSB prudential guiding standards

The Capital Adequacy Ratio (CAR) is a regulatory measure that provides a degree of solvency assurance of the financial institutions. This measure applies to the three sectors comprising the financial sector (banks, insurance companies and capital markets). The measure, however, is more sophisticated and internationally implemented in the banking sector than in the insurance and capital market. This section, therefore, attempts to briefly cover this solvency measure within the three main financial sectors.

2.1.1 Solvency and CARs for Islamic banking institutions

Banks' capital represents the first component of the protection framework for banks' depositors and creditors. This linkage between capital and deposit marked the emergence of the first regulatory capital adequacy ratio known as "deposit to capital ratio". Since its inception in the 1900s, the ratio has been adopted by financial regulatory authorities to oversee the banks' solvency and ability to payback its depositors. However, the main criticism of this ratio is that capital is supposed to provide protection against losses resulting from asset depreciation, and therefore, using deposits from the liability side in the ratio will not reflect the risk of those losses.[51]The notion of incorporating a risk element into the ratio paved the way to the 1988 agreement known as Basel I Accord. The Accord was the first endeavor by international central banks to establish a risk-based capital adequacy regulatory ratio. The Cooke Ratio, which was the key result of the Accord, introduced the concept of the credit risk exposure of the assets (also referred to as total risk-weighted assets RWA) as the denominator in computing the capital adequacy ratio. In 1999, the Basel Committee proposed the Basel II Amended framework, which was then implemented approximately in 2007. In addition to the capital charge for credit risk in Basel I accord, Basel II framework added a capital charge for both market risk associated with the banks' trading books as well as a capital charge for operational risk.[52]

During the global financial crisis of 2007, the market lost confidence in the banking sector in terms of its solvency and liquidity. As a response, the Basel Committee revealed that the definition of capital needed to be revised and that the emerging liquidity risk, which adversely affected the financial and economic sectors, must be integrated into the regulatory reforms. And the reforms represent the new Basel III accord in which the quality as well as the quantity of the regulatory capital base on one hand and the risk-weighted assets framework on the other hand must be enhanced. In that manner, the new definition of capital mostly focuses on the common equity, the Tier 1 capital, which is the highest quality of a bank's capital. The new accord also included a leverage ratio that restrains excess leverage in the banking system.[53]

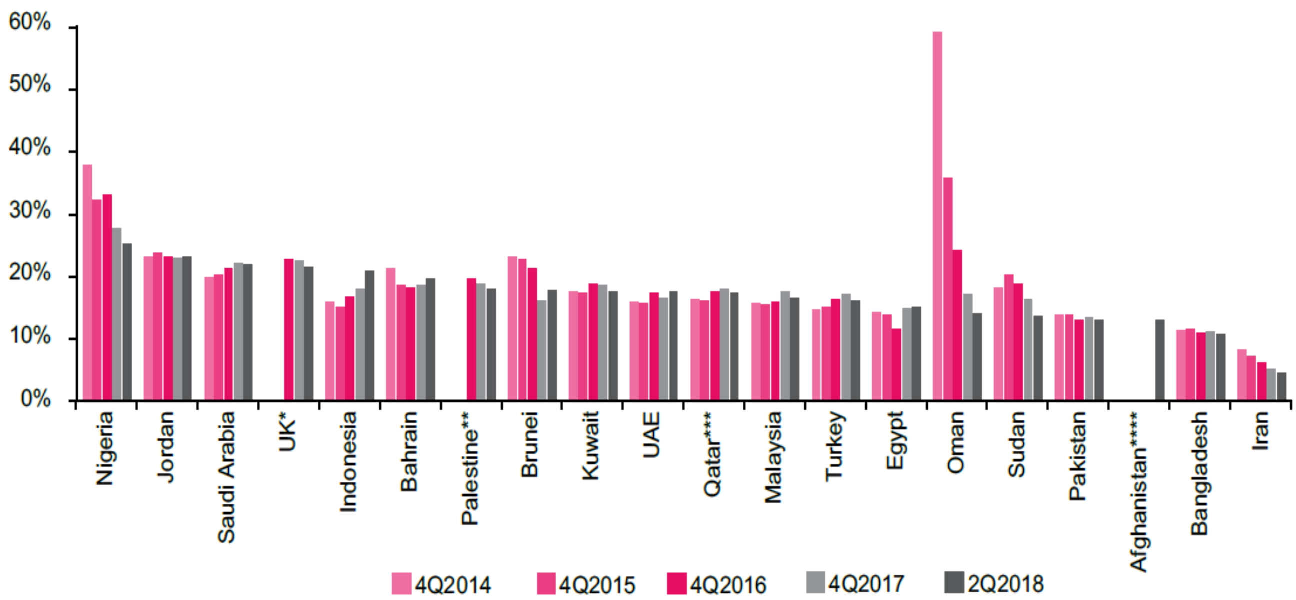
In addition to the enhanced minimum CARs, Basel III requires banks to build up a capital conservative buffer during normal conditions, which can be run down during incurred losses. Moreover, Basel III also requires a countercyclical buffer, particularly during excess credit growth, which can be relaxed once the market cools down again.[54] In this context, the IFSB also adopted similar measures for CARs and solvency to ensure Islamic banks maintain their capital solvency as well as liquidity position. Furthermore, IFSB's capital adequacy prudential guidelines also consider some unique features that differentiates Islamic banks from their conventional peers from both the asset and liability side of the balance sheet. IFSB's guidelines also classify *Shari'ah* non-compliance risk as an operational risk within the risk-weighted assets framework.[55]

Pursuant to the eligible components of the capital base for the CAR computation, Islamic banks may issue loss absorbing *Musharakah Sukuk* to qualify as Additional Tier-1 (AT1) capital. Similarly, Islamic banks may also issue convertible *Mudarabah* or *Wakalah Sukuk* Tier 2 capital instruments, which would be converted into common equity shares in the event of non-viability or insolvency of the issuing bank.[56] Accordingly, the 2018 global sukuk market witnessed a number of Islamic banks in different jurisdictions issuing Tier-1 perpetual *Sukuk* to meet their Basel CARs.[57]

In principle, IAs do not qualify to be included in the capital base for the CAR calculation as they do not represent any type of risk for the Islamic bank. However, from a practical point of view, due to the smoothing practices for the profit payout to IAs, a portion of risk known as the displaced commercial risk (i.e. profit volatility) is transferred to the Islamic bank's capital. As a result, a portion of the RWA funded by the IAs is required to be incorporated in the denominator of the CAR.[58]The IFSB's capital adequacy revised standards also aim to assist IFSB member countries in assessing potential domestic systemically important banks (D-SIBs) within their jurisdictions. This is to put in place additional capital regulatory requirements for such D-SIBs to reduce future public costs in case they fail and become insolvent.[59]

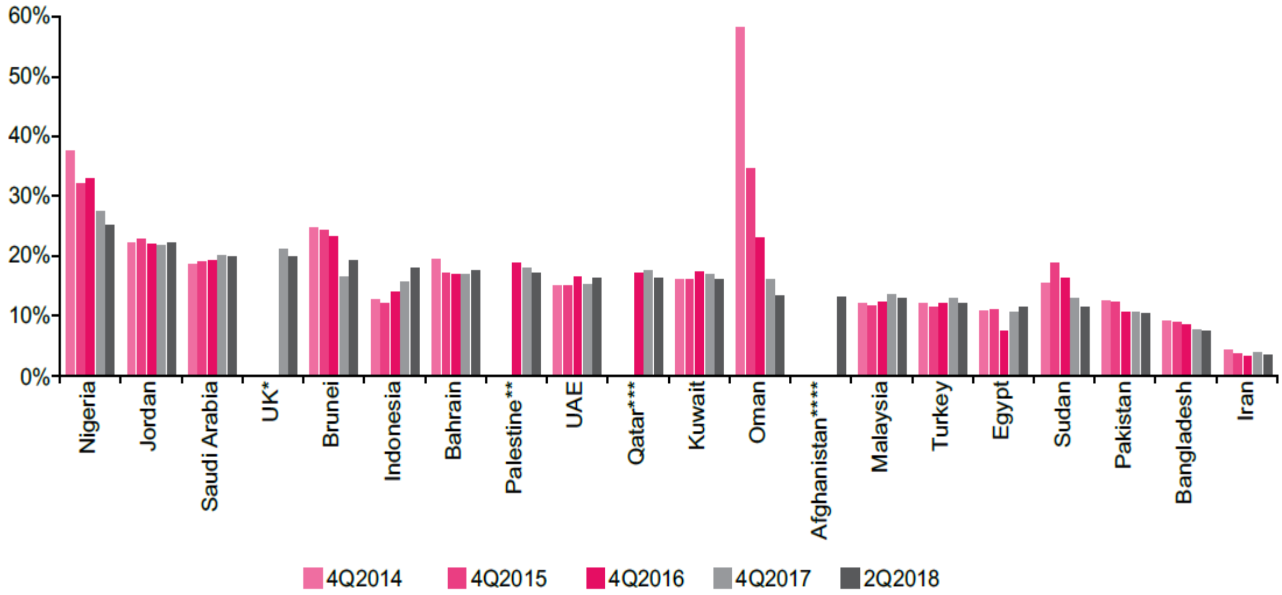
With regards to Basel III capital adequacy implementations, regulators in the Gulf region have already expressed satisfaction that banks started following Basel III requirements effective from December 2017.[60] Furthermore, the last IFSB stability report 2019 reiterated that the total capital and Tier-1 capital adequacy ratios for Islamic banks in most countries are stable and above the minimum regulatory requirements.[61] The following charts further illustrate that.

Chart (2) Islamic Banking Average Total Capital Adequacy Ratio by Country (4Q14–2Q18)



Source: IFSB, Financial Stability Report 2019

Chart (3) Islamic Banking Average Tier-1 Capital Adequacy Ratio by Country (4Q14–2Q18)



Source: IFSB, Financial Stability Report 2019

A brief comparison between the two charts demonstrates that the total CAR in almost all jurisdictions where Islamic banks operate, including Kuwait, consists mainly of the Tier-1 high quality capital. Regarding the case for Kuwait, the governor of the Central Bank of Kuwait (CBK) provided reassurance that the Kuwaiti banking system has been maintaining a stable and robust liquidity and capital adequacy levels since 2014, as banks have been required to comply with Basel III capital adequacy regulation.[62] The CBK report further highlighted that in 2018, the CAR had reached 18.3%, exceeding CBK's requirement of 13% in accordance with Basel III minimum requirements. Additionally, within the same year, Tier-1 capital accounted for 90% of the total capital.[63] In terms of strengthening Kuwaiti Islamic banks' capital base, there have been several Tier-1 *Sukuk* issuances during the past few years. In 2017, Warba bank and Ahli United Bank issued Tier-1 perpetual *Sukuk* in the amount of $250 million and $200 million respectively.[64] The CBK also allows the issuance of *Shari'ah* compliant additional Tier-1 capital instruments with bail-in features based on *Murabahah* contract.[65]

2.1.2 Capital requirements for Islamic non-banking institutions (insurance and capital market sectors)

After elaborating on the capital adequacy requirements for the Islamic banking sector under Basel Accords as well as IFSB capital adequacy, it is also essential to illustrate on the solvency and capital requirements for the non-banking sector which is comprised mainly of the Islamic insurance sector and the Islamic capital market.

Pertaining to the capital regulation for the insurance industry, solvency-II is the primary regulatory framework that was initiated by the European Union in 2016. It requires minimum capital requirements for a range of risk exposures including underwriting risk, operational risk, and investment risk. The structure of Solvency-II is largely similar to Basel framework.[66] According to the Insurance Core Principles (ICP) issued by the International Association of

Insurance Supervisors (IAIS), the regulatory authorities require insurers to hold a minimum CARs to maintain their solvency and ability to absorb significant unforeseen losses while continuing to meet their obligations toward the policyholders as they fall due even in the case of adversity.[67] The capital requirements thereby must be adequate and relevant to the risks insurers undertake. From a macroeconomic perspective, the capital adequacy requirements for insurers will eventually strengthen the safety and robustness of the overall financial system.[68]

The IFSB adopted and adapted the ICP set by the IAIS to align the Islamic insurance regulation to the sound regulatory framework in the conventional insurance industry. The IFSB standard on solvency requirements for *Takaful* undertakings highlights that given the feature of separate funds in the *Takaful* Operator (TO) (*Takaful* Participants' Fund and TO's fund which is the shareholders' fund or capital), solvency requirements must be covered within two distinct levels. The first level of solvency requirements is to ensure adequate capital resources in the PRF to continue to meet claims from *Takaful* participants when they fall due even during adversity. The second level of solvency is to hold adequate capital resources from shareholders' fund. This is to meet the financial and legal obligations of the TO including the potential need to extend capital support in the form of *Qard Hasan* or interest-free loan facility to the PRF.[69] Additionally, once a *Qard* facility is identified as a source of a solvency capital provision, the assets backing that facility should be recognized and identified to satisfy the supervisory concern.[70]

Pertaining to the CARs for financial markets, the main objective underlying this capital requirement is to provide customer protection and to enhance confidence in the financial markets. In the absence of such regulatory capital requirements, the failure of a security firm will raise doubts on the solvency of other firms and may adversely impact the entire financial market.[71] Accordingly, the IFSB within its capital adequacy standard for *Sukuk* and securitization has emphasized on similar objective as stated above. This includes previously published reports by the International Organization of Securities Commissions (IOSCO). Furthermore, IFSB requires Islamic financial institutions in the capacity of originators of securities (including *Sukuk* instruments) to maintain a minimum regulatory capital against all of their retained securitization exposures, including the extension of credit enhancement or a liquidity facility.[72] Essentially, the market intermediaries are subject to capital adequacy and liquidity requirements that are capable of maintaining their solvency positions.[73]

2.2 An analysis of Basel III compliant Sukuk (case for Kuwaiti Islamic Banks)

After the introduction of the Basel III regulatory framework post the global financial crisis, the financial markets witnessed the emergence of a new type of Sukuk. These new Basel III compliant Sukuk aim at meeting the CARs and insolvency measures especially for Islamic banks. Hereof, starting from year 2012, a number of IFIs managed to issue Tier 1 and Tier 2 Sukuk.

The full-fledged five Kuwaiti Islamic banks which operate within the Kuwaiti Banking sector are required to maintain a robust capital adequacy under the Basel III capital framework. In this regard, there have been several Tier 1 Sukuk issuances by Kuwaiti Islamic banks in the past couple of years. The table below further illustrates these issuances as of December 2019.

Table (2): Tier 1 Sukuk Issuances by Kuwaiti Islamic Banks as of December 2019

Issuer	Issue Size (000,000)	Issue Date	Tenor	Structure	Exchange	Over-Subscription	*Call Option
Boubyan Tier 1 Capital SPC *Sukuk* Limited	USD 250	May 2016	Perpetual	*Mudarabah*	-Irish Stock Exchange -NASDAQ Dubai	5 times	5 years
Ahli United *Sukuk* Limited	USD 200	October 2016	Perpetual	*Mudarabah*	-Irish Stock Exchange -NASDAQ Dubai	3 times	5 years
Warba Tier1 *Sukuk* Limited	USD 250	March 2017	Perpetual	*Mudarabah*	-Irish Stock Exchange -NASDAQ Dubai	5 times	5 years
Kuwait International Bank Tier 1 *Sukuk* Limited	USD 300	June 2019	Perpetual	*Mudarabah*	-Irish Stock Exchange (known now as Euronext Dublin)	15 times	5 years

Source: Sukuk issuances Prospectuses & Bank's Annual Reports

In general, all Kuwaiti Basel III *Sukuk* issuances were oversubscribed by at least three to five times and received a strong demand from investors in the Middle East, Asia, and Europe. The oversubscriptions reflect the confidence in these financial markets and the financial position and performance of these issuers, as well as the overall strength of their credit worthiness.

It is noticeable that all Kuwaiti Islamic banks made a single issuance of Tier 1 Sukuk with the exception of Kuwait Finance House (KFH). However, The KFH Turkish subsidiary issued a 10-year maturity Tier 2 *Sukuk* amounting to USD 350 million in February 2016[74]. Also, as of December 2019, there exists no Kuwaiti Tier 2 Sukuk issuance, while this type of capital boost *Sukuk* is already in existence in other Gulf Cooperation Council (GCC) countries, Malaysia, Turkey, and Pakistan.

Before going into further details with regards to Basel III compliant *Sukuk*, it is of importance to firstly discuss its conventional peers, which are the contingent convertible bonds (CoCos). The global financial crisis caused high volumes of public bailouts for troubled financial institutions worldwide under the notion of 'too big to fail'. Among the reforms post the crisis is to avoid such bailouts that constitute a burden on the taxpayers and affect the public view of the banking sector. This initiative has driven the development of innovative financial instruments with capital loss absorption capacity (bail-in) known as CoCos. These AT1 bonds can absorb capital loss at a predetermined insolvency event either by way of principal write-down or converting to equity.

As alternative *Shari'ah* compliant capital loss absorption instruments, IFIs can issue equity equivalent perpetual AT1 *Musharakah Sukuk* (with the underlying assets being the entire IFI business). The IFIs may also issue callable, convertible Tier 2 *Mudarabah* or *Wakalah Sukuk* for a maturity not less than five years[75]. Pursuant to this, Tier 2 *Sukuk* appears to be the closest structure for a *Shari'ah* compliant CoCos. This analogy is attributed to the irrevocable

[*] Call Option means that the bank has the right but not the obligation to repurchase the certificates after a period of time subject to stipulated events and circumstances.

convertibility provision to equity at the point of non-viability or insolvency. On the other hand, AT1 *Sukuk* are classified as equity holders since the initial issuance and are not required to integrate the convertibility or principle write-down provision in their terms.

The irrevocable convertibility and principle write-down provision, especially under *Mudarabah Sukuk* structure, may raise a *Shari'ah* issue. Under a separate *Mudarabah* pool from the general business of the IFI, *Mudarabah* capital provider is not liable for the general liabilities of the IFI, but only bears the losses related to the separate *Mudarabah* pool. In this regard, the IFSB released the Exposure Draft-23 (Revised Capital Adequacy Standard for Institutions Offering Islamic Financial Services-Banking Segment) in November 2019 and which is not yet finalized. In this exposure draft, the IFSB made an adjustment as compared to the previously issued standard (IFSB-15) where it did not specify any particular type of *Shari'ah* contract for the structure of convertible Tier 2 *Sukuk*[76].

Based on the above analysis, *Mudarabah* is not the most appropriate underlying contract for convertible Tier 2 *Sukuk*, therefore, IFIs should utilize more compatible contracts (i.e. *Murabahah*, *Ijarah*), taking into consideration the *Shari'ah* rulings regarding the combination of contracts in a single structure. Moreover, if the *Mudarabah* pool is commingled with the general business of the IFI and its assets, then this *Sukuk* certificate is in fact a capital loss absorbance vehicle and a type of *Musharakah* Tier 1 *sukuk* (which is the case of all the four issuances in the table (2) above).

The demand side of the previously mentioned Tier 1 *Sukuk* issuances is manifested by their oversubscriptions and their large investor base both international and regional. This success can pave the way for future issuances. In order for perpetual *Sukuk* to be more attractive especially to international investors, it should possess active liquid secondary markets. This prerequisite requirement is mainly due to its perpetuity nature and its similarity to common shares. In addition to that, liquid secondary markets will help this instrument gain a more fair and straightforward valuation method which will help enhance its trading volumes.

In short, it is worth noting that Basel III compliant *Sukuk* as a capital loss absorbance (bail-in) instrument can play a pivotal role within an effective and orderly Islamic finance insolvency regime. It can support the banking regulatory and supervisory authorities in various jurisdictions to reduce the overreliance on taxpayers' funds in rescuing troubled financial institutions. Also, structuring this instrument using profit and loss sharing contracts such as *Musharakah* and *Mudarabah*, in their genuine application, is at the heart of risk sharing and Islamic finance essentials and objectives.

2.3 Stress testing for major risk categories

Since the global financial crisis, stress testing has become a powerful proactive supervisory tool to assess the resilience and soundness of the banking sector as well as other financial sectors. However, the validity of stress testing results is affected by a number of factors including data availability and quality, and its models' capacity to capture contagion effects and interlinkages. Hence, stress testing shall not be implemented on an individual basis, but rather be used in combination with other tools and measures to provide a consistent supervisory assessment framework. Such additional tools are for instance a systemic risk monitoring or capital planning review[77].

Stress testing can be defined as a forward-looking exercise that aims to examine the impact of severe but plausible adverse scenarios on the soundness and stability of financial institutions.[78] Stress testing is a quantitative framework that estimates the adverse effect of a range of potential risks embedded in hypothetical events on capital and income streams. A coherent stress testing framework incorporates both solvency and liquidity scenarios. Hence, it evaluates two aspects of financial institutions' performance, which are solvency and liquidity.[79] Furthermore, a solvency stress test assesses whether the financial institution holds sufficient capital to maintain its solvency position, particularly in a possible adverse macro-economic environment.[80] In this regard, solvency is measured by a range of capital ratios including, but not limited to, the regulatory capital adequacy requirements in addition to the recently implemented leverage ratio.[81]

Basel Committee established a set of stress testing principles as a guideline and best practice for both financial institutions and supervisory authorities. Meanwhile, the committee considers stress testing to be integrated within the supervisory oversight framework. The following are the main principles of a stress test adopted by the Basel Committee.

a) Stress test framework should incorporate a comprehensive governance structure.[82]
b) Stress test framework should capture all material and relevant risks taking into consideration the new emerging risks. The scenarios applied in the stress test should be adverse, plausible and should be reviewed on a regular basis to ensure their relevance.
c) A well-developed information technology system and accurate data are prerequisite elements of an effective stress test framework. Also, the stress test models and outcomes should be subject to a regular review.
d) Stress test findings should be disclosed in order to strengthen the market confidence with regards to the resilience of the banking sector and the financial sector as a whole.[83]

From a regulatory perspective, an effective stress test shall be designed in line with supervisory objectives. Also, stress tests can take a macro prudential or a micro prudential approach. In a macro prudential approach (systemic stress test), the stress test assesses the system-wide resilience to financial and economic adverse conditions. This approach takes into consideration contagion among financial institutions as well as linkage effects with the broader financial and economic sectors. On the other hand, the micro prudential approach is designed to evaluate the resilience and stability of an individual bank to financial and economic risks, vulnerabilities and macroeconomic shocks.[84] Moreover, at times of crisis, a combination of these two approaches into a single comprehensive framework may be needed for capturing both bank-specific risk and systemic risk with the aim of restoring market confidence.[85]

A stress testing framework should reflect all major risk categories and exposures. Such risks are credit risk exposures, market risk in relation to the trading positions of the financial institution, interest rate or rate of return risk in the banking book, liquidity risk and its potential impact on the solvency position of the financial institution, risk arising from securitization activities, operational risk (including *Shari'ah* non-compliance risk), and finally, financial group risk related to the affiliation of a financial institution as part of a financial group. These risk categories may emerge particularly as a result of contagion within the financial group.[86]

Pertaining to the insurance sector, stress testing is increasingly gaining acceptance as a risk management and supervisory oversight tool. From a financial stability standpoint, a stress testing for the insurance sector is as important as for the banking sector. When insurance companies provide large scale protection schemes for various risk exposures that are linked to the broader financial sector, any potential failure could trigger a systemic risk to the entire financial sector.[87]In a similar pattern, the Islamic insurance industry is in the process of implementing a stress testing framework in addition to other tools and accounting measures to strengthen the Islamic insurance sector.[88]

2.4 Conducting a solvency stress test as per IFSB-13 guiding principles

As mentioned earlier, stress testing aims to provide a forward-looking assessment of all potential risks within various adverse but plausible scenarios. Thus, a low frequency high impact scenario-based stress test framework could overcome the limitations embedded in models largely based on historical data.

During the early stages of the global financial crisis of 2007, IFIs appeared to be more resilient as compared to their conventional peers. However, once the crisis reached its peak, affecting both the financial and economic sectors, IFIs were also vulnerable but not as heavily as the conventional financial institutions. One of the reasons was the *Shari'ah* restrictions in regard to debt selling and securitization as well as trading and speculation in derivative instruments, which were among the major factors that triggered the crisis. Furthermore, the fact that IFIs were vulnerable to adverse events in different manner implies that IFIs are in a need to establish a stress testing framework while complementing the international stress testing guidelines. Hence, the IFIs should also be able to capture its unique features and risk categories (such as the risk inherited in the investment accounts).

The IFSB attempted to establish a comprehensive and coherent stress testing framework that could reflect the salient features of Islamic finance and banking systems. The Board stated in its IFSB-1 guidelines that IFIs should conduct a due diligence process that includes a stress test to assess and select eligible counterparties.[89] Following that, the IFSB-5 standards stated that the supervisory authorities should require IFIs, for risk management purposes, to put in place a forward-looking stress test framework that incorporates plausible scenarios that could adversely affect the IFIs' financial performance.[90]

Subsequently, the IFSB-13 standard on guiding principles for stress tests for IFIs was issued with the aim of overcoming the gap and providing a comprehensive stress testing framework as a key risk management and supervisory oversight tool. This tool could help assess the resilience and safety of the Islamic finance system as a whole. Moreover, the guiding principles within the standard can be considered as a benchmark and best practice available for both IFIs as well as supervisory authorities. This is to establish proper stress test frameworks and regularly review them, taking into account the dynamic nature of the markets as well as emerging financial technologies. The main objective of the stress test framework highlighted in the IFSB-13 standard is the potential to evaluate the IFIs solvency in terms of meeting the capital requirements, particularly during reasonably severe financial and economic environments. From a regulatory perspective, stress testing can be used as an oversight tool that provides a regular assessment with respect to the resilience and safety of the financial system.[91]

On top of the common principles that both the stress test framework for IFIs and conventional institutions may share, there are some distinguished principles that are meant to capture specific concerns within the Islamic banking and financial sector. In this regard, IFIs should include specific scenarios that could effectively capture the presence of both restricted and unrestricted investment accounts.[92] Furthermore, IFIs holding and transacting in *Shari'ah* compliant securities (such as *Sukuk*) should take into consideration –in addition to common risks such as market risk –the potential legal and *Shari'ah* issues that might emerge from the securities structure and contractual agreements.[93] IFIs should also encompass all material and relevant risks at different stages arising from specific portfolios from both asset and liability sides such as commodity *Murabahah* transactions and equity-based transactions (i.e. *Mudarabah* and *Musharakah* investments). For example, the wide usage of commodity *Murabahah* in most of the Islamic finance jurisdictions might eventually trigger a systemic market risk or commodity price volatility. With respect to liquidity risk, IFIs should conduct a range of liquidity stress scenarios under different circumstances in order to assess potential liquidity stresses.[94]

In essence, both IFIs and supervisory authorities should: (i) consider stress testing as an integral part of their risk management processes; (ii) capture all specific, material and relevant risk, including potential emerging risk; and finally, (iii) encompass the correlation and contagion risks within a system-wide stress testing framework.

2.5 Designing a stress testing framework for IFIs (joint stress testing of solvency and liquidity)

Liquidity risk is defined as the uncertainty of loss arising from failure to secure funding at a reasonable cost (funding liquidity risk), to sell (or pledge) an asset without giving up a portion of its value (market liquidity risk), and meeting expected or unexpected obligations when they fall due.[95] The concepts of these emerging risks were poorly understood during the recent financial crisis which led to further deterioration of the financial and economic sectors. The spillover of the dramatic events during the financial crisis clearly depicts the interrelationship between liquidity and credit risk and the perception that liquidity is a key determinant to the soundness and resilience of the banking sector.[96]

The General Council for Islamic Banks and Financial Institutions (CIBAFI) asserted on its fourth Global Islamic Bankers' Survey 2019 that liquidity remains a crucial and top concern among several jurisdictions where Islamic banking operates. Meanwhile, a number of these jurisdictions maintain a substantial amount of idle liquidity mainly due to the absence of appropriate *Shari'ah* compliant liquidity management instruments.[97] A liquidity stress test aims to evaluate whether a financial institution holds sufficient liquid assets and cash inflows to withstand expected and unexpected cash outflows in an adverse scenario. Furthermore, the nature of maturity mismatch in banks often puts them in liquidity risk even if it is otherwise solvent. In the same vein, liquidity and solvency stress events are often linked and overlapped. In other words, a liquidity shortage may transform into a solvency concern if the financial institution's assets can only be liquidated at a forced sale.[98]

Despite the fact that supervisory authorities around the globe may consider the importance of liquidity, particularly after the financial crisis, their stress test frameworks treated liquidity risk as independent of solvency risks. Moving forward, supervisors have made substantial progress in terms of developing new stress test models that incorporate both the interlinkage between liquidity and solvency risk from one side and the contagion risk among the financial institutions system-wide on the other side.[99]

The Basel Committee has initiated a regulatory liquidity stress test known as the Liquidity Coverage Ratio (LCR) to assess and monitor the liquidity of banks in the short term. It also established the Net Stable Funding Ratio (NSFR) for the assessment of long-term liquidity. This initiative was a response to the importance and adverse effects that liquidity may play in the failure of financial institutions and the deterioration of the financial sector. The LCR is a supervisory liquidity stress test within the Basel III framework. Its main objective is to ensure that banks have sufficient stock of unencumbered High-Quality Liquid Assets (HQLA), which can be easily and at a low or no cost converted into cash, to meet its liquidity obligations within a 30-calendar day liquidity stress scenario. The scenario includes a combination of idiosyncratic and market-wide shocks that would lead to a potential retail deposit run or a partial inability to obtain unsecured wholesale funding.[100]

Pertaining to the LCR in Islamic banking sector, the IFSB 2019 Stability Report reaffirmed that almost all Islamic finance jurisdictions maintain a level of LCR above the regulatory minimum requirement. Similarly, in 2018, Kuwait showed a comfortable level of LCR above the regulatory requirement.[101] The IMF also confirmed in its country financial stability report that Kuwait's liquidity stress test shows resilience in the banking sector. The report also highlighted that under both normal and severe stress scenarios, all but one bank including both Islamic and conventional banks would maintain LCR above the 100 percent regulatory ratio.[102]

There are several aspects where stress testing can be further enhanced, wherein the treatment of solvency and liquidity risks remains in one single coherent framework. There was a recent proposal for a joint stress testing of solvency and liquidity, whereby, the proposed model analyzes and captures the interactions and linkages between the liquidity and solvency of a financial institution's balance sheet under a stress scenario.[103] From a risk perspective, IFIs and its conventional peers share similarities. In this regard, the proposed joint stress testing can be adopted and adapted to provide a comprehensive supervisory assessment tool for the Islamic financial sector.

2.6 Protection framework for the IFIs

The recent global financial development report for 2019/2020, released by the World Bank, highlights that many jurisdictions around the globe have already enacted, or are in the process of enacting, new laws and regulations, which includes bank resolution regimes as well as consumer protection frameworks.[104] Financial consumer protection instruments can be divided into two categories. The first category is the consumer protection in regard to a going concern financial institution. In this case, consumers can resolve their disputes with a financial institution via dispute settlement schemes (including courts). The second category of consumer protection is with a 'gone concern' financial institution (the institution is wound up). In this case, consumer protection can contain the financial loss through, for instance, a deposit insurance scheme.[105]

The BCBS has established a set of core principles for effective banking supervision. The core principles set out the primary objective of the banking supervision in promoting the safety and resilience of the banking sector. In light of that, the banking supervision may obtain the power and responsibility for consumer and depositor protection.[106] Moreover, a well-developed public infrastructure should encompass, among other components, a consumer protection framework.[107]

The IFSB also issued its set of Core Principles for effective Islamic Finance Regulation (CPIFR) for the banking segment. The CPIFR aims to provide a benchmark and best practice for the supervisory authorities in addressing the safety and soundness of the IFSI. It also aims at protecting consumers and other relevant stakeholders by ensuring that the *Shari'ah* compliance concerns are well set and explicitly disclosed.[108] The IFSB guideline further envisages that supervisory authorities will address and ensure (IAHs) protection.[109] Similarly, the IFSB-22 standard emphasizes the infrastructure components, including but not limited to, investor protection (rights of IAHs and shareholders) as well as depositor protection frameworks. These components are essential to promote market discipline.[110]

Pertaining to the capital market segment, strengthening laws and legal systems (such as enforcement of contracts) may play a pivotal role in enhancing investor protection and contributing to the deepening of the capital market. Investor protection can also be enhanced by putting in place well-developed accounting and disclosure standards and promoting corporate governance best practices.[111] For the main objectives of Islamic capital market regulation are to protect investors, ensure market transparency and reduce systemic risk. However, supervisors need to take into consideration the salient features inherent in Islamic finance. For example, for the purpose of developing an investor protection framework, *Shari'ah* compliance matters should be well established and clearly disclosed and documented leaving no room for ambiguity or misleading elements within the contractual agreements. Accordingly, investors in the Islamic capital markets have the right to obtain clarity in their contractual agreements with respect to the governing laws that will resolve cases of arguments as well as how courts will duly address *Shari'ah* related disputes.[112]

The IFSB is in the process of establishing a standard with regards to Investor Protection in Islamic Capital Markets (IPICM). The IPICM standard aims to provide best practices for investor protection framework taking into consideration Islamic finance's salient features, particularly *Shari'ah* compliance related matters. The standard also attempts to boost harmonization of regulatory practices across member jurisdictions.[113] In the same pattern, IFSB recently issued an exposure draft no 24 "Guiding Principles for IPICM" on March 24, 2020, for the aim of obtaining comments and feedback from market participants.

One of the predominant financial instruments in the Islamic capital markets is *Sukuk*. Although *Sukuk* are often perceived as a safer alternative to traditional bonds, the subsequent near and actual *Sukuk* default events during the past few years have raised serious enquiries with respect to investors' rights. Furthermore, some *Sukuk* structural deficiencies could end up revoking the investors' right of recourse and the enforceability of *Sukuk* agreements.[114] Furthermore, it is apparent that one of the key impediments in the growth and development of *Sukuk* market is the insolvency and investor protection issue, in addition to the lack of standardization of both *Sukuk* structures and governance.[115]

From the investor protection perspective, the debate is often focused on the investors' legal entitlement to the underlying assets of the *Sukuk* agreement in the event of default or insolvency of the issuer or originator. In practice, however, the legal ownership of the underlying assets for the majority of *Sukuk* structures and issuances is not transferred from the originator to the *Sukuk* holders because of legal and tax restrictions. As a result, in the event of default, *Sukuk* investors do not take control of the assets; instead, they can have recourse to the originator. Finally, another investor protection concern is *Sukuk Shari'ah* governance. This issue is related to the regular and transparent disclosure and review of *Shari'ah* compliance related matters, which remains a top discussion among stakeholders and policymakers.[116]

In view of the above, the International Islamic Financial Market (IIFM), a standard-setting body focusing on Islamic financial markets, is in the process of developing *Sukuk* standards for *Sukuk Al-ijarah* and *Sukuk Al-mudarabah* to provide a standardized documentation and practice for *Sukuk* instrument across jurisdictions. In the same pattern, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) recently issued the *Sukuk* governance standard in December 2019. These much-needed initiatives aim at enhancing standardization and governance of IFSI, thereby strengthening the stakeholders' protection framework.

Section 3: Insolvency & liquidation systems in IFIs

3.1 Internationally recognized principles for effective insolvency and creditor rights systems
3.2 *Shari'ah* views and principles on insolvency (*Iflas)*
3.3 Islamic finance and the impact of insolvency
3.4 Issues in the insolvency regime for the IFIs
3.5 An overview of the distressed Islamic financial Instruments in Kuwait
3.6 Developing an effective insolvency regime for IFIs

A well-established insolvency and creditor rights regime facilitates the extension of credit and enables private sector development. By providing the restructuring and preservation of distressed yet viable businesses and alternative for the orderly resolution of distressed non-viable businesses, the insolvency laws offer predictability and enhance investor confidence.

3.1 Internationally recognized principles for effective insolvency and creditor rights systems

Insolvency simply means a situation where the liabilities of a business such as a financial institution exceeding its assets.[117] It is worth mentioning at the outset of this section that the vast established literature has not distinguished between 'insolvency' and 'resolution' and tends to use them interchangeably. Therefore, in this paper, insolvency and resolution will also be used to provide a similar meaning. Insolvency proceeding aims at preserving the survival of the debtor on one hand and satisfying the rights of the creditors on the other hand. However, which one of the two objectives should be deemed as the crucial target depends on each jurisdiction and its insolvency law objectives.[118] By maintaining businesses on a viability basis, new projects will then replace the non-viable ones and, therefore, insolvency proceedings can be seen as a requirement and an effective tool for boosting economic growth.[119]

3.1.1 The United Nations Commission on International Trade Law (UNCITRAL) key objectives for an effective insolvency regime

Technically speaking, an insolvency proceeding is a mechanism that satisfies the outstanding claims of creditors and other stakeholders toward a debtor who is incapable of paying financial obligations as they fall due.[120] Besides, the insolvency proceedings should consider both reorganization and liquidation as a way of handling a failing business.[121] These two choices are used sequentially. Meaning, the liquidation[122] will only run their course if reorganization is unlikely to be successful or if reorganization efforts fail.[123] The focus on reorganization may serve several aims, such as enhancing the value of creditors' claims as part of an ongoing business concern, providing a second chance to the debtor, and protecting vulnerable groups such as the debtor's employees from the effects of business failure.[124] Accordingly, the commencement of insolvency proceeding is based on two standard analyses: (i) when debtors is unable to pay, on an ongoing basis, their outstanding financial obligations as they fall due; and (ii) when liabilities exceed assets (balance sheet test).[125]

The UNCITRAL has established a set of key objectives of an effective insolvency system. The following is a summary of these key objectives.

1. An effective insolvency system should provide a level of certainty in the market to foster financial stability and economic growth.
2. It should maximize the value of the assets resulting in a higher distribution to creditors and other stakeholders.
3. It should also create a balance between reorganization and liquidation by examining the potential of reorganization to increase the value of a failing but potentially viable debtor to both creditors and to society as a whole.
4. It should safeguard an equitable treatment among creditors with similar legal rights.
5. It should disseminate a transparent and predictable insolvency proceeding environment. The proceeding should also be impartial, prompt and efficient.
6. It should set up clear rules for ranking the claims and rights of different creditors and stakeholders.
7. Finally, an effective insolvency regime should incorporate a cross-border insolvency proceeding framework.[126]

3.1.2 World Bank principles for an effective insolvency and creditor/debtor rights regime

The World Bank has set up various principles for effective insolvency regimes (the Principles). These Principles are considered international best practices and were introduced to be consistent with the above mentioned UNCITRAL key objectives. They are the result of a long-term collaboration between the World Bank, the UNCITRAL and the International Association of Insolvency Regulators (IAIR). These principles were initially developed in 2001 as an initiative to cope with the significant absence of internationally recognized standards for insolvency proceedings, especially during the financial crisis in emerging economies in the late 90s. Ever since then, these principles have been regularly updated (the last update was in 2015).

They are currently suitable to be applied as a benchmark by all jurisdictions in relation to the development and assessment of their domestic insolvency regimes and creditor/debtor rights.[127]

The principles are divided into four distinguished parts. Each part consists of several elements. The following is a summary of the principles. Part one focuses on creditor/debtor rights. In this regard, a credit system should be within a consistent commercial law system that aspires to (i) promote reliable credit protection methods and reduce non-performance or default risks; (ii) orderly and equitable treatment of creditors and debtors' rights; and (iii) predictable insolvency proceedings to address and satisfy credit claims. A well-functioning credit system should be backed by procedures that sufficiently satisfy creditors' rights whether through court proceedings or informal out of court dispute resolution[12].

The second part of the principles is related to risk management and informal corporate workouts. An informal corporate workout framework is backed by an enabling environment that encourages creditors and debtors to revert to informal proceedings such as voluntary negotiation, mediation or out of court dispute resolution to reorganize and restore a troubled yet potentially viable business.[128]

The third part of the principles is regarding the legal framework for insolvency. The principles herein adopted similar objectives of an effective insolvency regime as the UNCITRAL did, whereby an effective regime aims to: (i) provide for efficient and fair insolvency proceedings; (ii) find an appropriate balance between reorganization and liquidation proceedings and allow for a smooth conversion between the two; (iii) set a clear and predictable process for the ranking of the priority of creditor claims; and (iv) initiate a cross-border insolvency framework. It is also a prerequisite to put in place certain tests and criteria, which lead to the commencement of insolvency proceedings. Furthermore, a creditors' committee can be created in order to preserve the creditors' rights and ensure their active participation and involvement in the insolvency proceeding. The committee can be empowered to take part in key issues and decisions to maintain the transparency and integrity of the insolvency proceeding towards the creditors.[129]

The fourth part is related to the institutional and the regulatory framework. This part refers to the transparency and accountability embedded in the insolvency and creditor rights regime. Besides, regulatory authorities have the responsibility of supervising insolvency representatives (which is the administration that conducts the insolvency proceeding). Furthermore, criteria as to who may be an insolvency representative should be clearly established and made publicly available. Insolvency representatives should also act with integrity, impartiality, and independence[130].

Last but not the least, it is worth mentioning that besides the UNCITRAL key objectives and the World Bank's principles for effective insolvency regimes, there are other internationally recognized insolvency regimes. These include the FSB's key attribute to effective resolution regimes for financial institutions and the Organization for Economic Co-operation and Development's (OECD) indicators of insolvency regimes. All of these globally recognized insolvency frameworks serve as benchmarks for the development of effective insolvency regimes at the country level.

Regarding the Case for Kuwait and its endeavors to establish an orderly insolvency regime, The IMF Multi-Country Report 2017 highlighted that the CBK, with the World Bank assistance, was in the process of establishing a standalone banking resolution regime. This special regime also incorporates the aspect of resolution proceedings of Islamic banks[131]. Accordingly, a separate bank insolvency law was subsequently submitted for approval in 2020.

Furthermore, this banking insolvency regime enables the CBK to make an early intervention in case of a bank's exposure to financial risks (i.e., insufficient bank assets to cover its obligations), or any improper banking practices that jeopardize the interests of its creditors. In this regard, article 5 of the draft law highlights the appropriate remedial measures. These measures range from; (i) the suspension of certain banking activities and transactions; (ii) an increase in the capital requirement; (iii) the approval of resolution proceedings including the restructuring of the troubled bank or its merger with another healthy bank. These measures aim at preserving the value of the bank's assets in order to protect the rights of depositors and other creditors[132].

3.2 *Shari'ah* views and principles on insolvency (*Iflas)*

All divine religions encourage their followers not to become debtors, but if they become so, under all circumstances, they are strictly required to repay their outstanding debts without delay.[133] *Shari'ah* (Islamic Law), which takes the Quran and prophetic traditions (*Sunnah*) as primary sources for its rulings, acknowledges the insolvency concept (*Iflas*). *Iflas* simply means the inability of the debtor to meet his or her financial obligations when they fall due. *Shari'ah* also provides a range of ethical remedies for such debt repayment difficulties. The following Quranic verse illustrates these facts.

"If the debtor is in a difficulty, grant him time till it is easy for him to repay. But if you remit it by way of charity, that is best for you if you only knew." (*Surah al-Baqarah*, V: 280).[134]

The verse seemingly recognizes and encompasses both reorganization and restructuring of the debt obligations (e.g., under a mutual agreement between creditor and debtor) as permissible and available tools for insolvency proceedings. Thus, it is vital to investigate the doctrinal underpinnings of these alternative tools, especially under the current practices of the conventional insolvency proceedings that mainly prefer debt reorganization and restructuring[135]. Conceptually, *Iflas* or insolvency within the *Shari'ah* principle includes the modern definitions of insolvency; namely, balance sheet insolvency and cash flow insolvency. Balance sheet insolvency means the situation where an entity's liabilities exceed its assets. While cash flow insolvency is when an entity has insufficient cash or highly liquid assets to meet its financial obligations when they fall due[136].

It is worth noting that the classical Islamic bankruptcy law only recognizes personal insolvency where the debtor has an ongoing obligation to pay his or her debts. In other words, the law does not distinguish between private and entity (corporate) bankruptcies, hence, lacks the establishment of the limited liability concept. As a result, the liabilities of a business entity would also be the duty of the sole owner, or the group of partners within the commercial partnership[137]. The reason why early *Shari'ah* scholars developed insolvency proceedings for individuals only, is that the modern corporate entities were not in existence hundreds of years ago[138].

With that being said, the separate legal entity concept was already known to the Muslim jurists because the *waqf* institutions (trust) and the public treasury are the two examples of independent legal entities that handle their affairs in their distinct name. Likewise, the *Shari'ah* principles also acknowledge the notion of limited liability. For instance, the beneficiaries of trust were not deemed liable to the debts of the trust. Similarly, in a *Mudarabah* agreement, the financier (*Rabb al-M*aal) provides the capital, and the entrepreneur (*Mudarib*) contributes the work, and the financier is liable for an amount up to his capital contribution. Furthermore, the vast majority of contemporary *Shari'ah* scholars and academicians approve the limited liability concept. Whereas the rest, a minority of them who do not approve the concept, base their argument on the potential misapplication of such protection, rather than rejecting the concept itself. [139] This essential recognition could smooth the integration of *Shari'ah* insolvency-related principles in the modern and globally accepted insolvency and creditor rights regimes.

However, it is noteworthy that there is some divergence between *Shari'ah* insolvency principles and conventional insolvency systems. Pertaining to the commencement of an insolvency proceeding under *Shari'ah* principles, only creditors are entitled to file a claim and initiate the proceeding. It is in contrast to the voluntary insolvency tools embodied in most of the modern debtor-friendly insolvency regimes, in which, the debtor can voluntarily commence an insolvency or bankruptcy proceeding. Moreover, the outcome of the insolvency process can be an increase in the amount of financial obligations because of debt restructuring. This outcome is tantamount to the prohibited interest (*Riba)* in the *Shari'ah* rulings.[140]

In response to the absence of comprehensive *Shari'ah* insolvency-related principles handling the corporate segment, AAOIFI has issued *Shari'ah* standard No. 43 with regards to the insolvency for IFIs. The standard states that competent authority can issue a declaration of insolvency and seize the assets of an insolvent debtor once it receives a claim by the creditors. In addition, the designated authority can, at the request of the creditors, restrain the insolvent debtor from causing any unfair treatment of the creditors or the insolvency assets. As opposed to the classical Islamic insolvency law, the standard permits a voluntary insolvency declaration by the debtor unless the respective authority considers the application to be fraudulent[141]. This practice is similar to the current trend in modern insolvency regimes.

From a maturity perspective, the debtor's undue debts will be accelerated and become all due as a result of the insolvency declaration. Moreover, it is permissible, with the creditors' sole discretion, to waive a portion of these undue debts, while the debtor merely remains morally obliged to pay his or her financial obligation in full. Creditors have no legal right to request any unpaid debt from the insolvent debtor[142]. It is also in contrast to the classical *Shari'ah* principles of insolvency and bankruptcy. For the distribution process, the standard ranks the secured creditors at the top of the claim hierarchy after the deduction of the insolvency process fees. Subsequently, the creditors who possess distinguished property within the stock of insolvency assets (e.g., investment funds, capital of *Mudarabah* or investment agencies) have priority and direct claim over it[143].

Finally, assets such as restricted deposits and investment funds that are managed on the basis of *Mudarabah* or investment agencies, and are not owned by the insolvent institution, cannot form a part of insolvency assets portfolio[144].

3.3 Islamic finance and the impact of insolvency

According to what has been highlighted above with regards to the AAOIFI *Shari'ah* insolvency standards, it can be seen that these guidelines have been designed for both individual as well as institutional insolvency proceedings under the *Shari'ah* rulings and principles. More importantly, the standards emphasize the significance of a public insolvency declaration by the requisite authority. It is worth mentioning that the *Shari'ah* rulings incorporated in the standards have many similarities with the UNCITRAL key objectives (e.g., maximizing the value of insolvency assets and impartial treatment of creditors' rights). It also shares some commonalities with the FSB key attributes, especially in the appointment and empowerment of a designated insolvency authority. The standards, however, need to be regularly revised in order to keep up with the developments of the modern insolvency regimes applicable to financial institutions.

Insolvency proceedings in Islamic finance may take the form of debt restructuring. This tool can be further divided into two sub-categories, debt restructuring through time extension. However, it should not involve any increase in debt as that will be tantamount to the prohibited interest (*Riba)*. Debt restructuring can also be through the initiation of a new contract that would facilitate the settlement of the previous contract. In this regard, it is essentially required from a *Shari'ah* compliance aspect, to settle the initial contract by an actual cash payment rather than a mere ledger transfer. Debt restructuring, in this case, must at all times avoid the debt for debt prohibition (*kali-bil-kali*). The second category is the rebates (haircuts) application. This practice is permitted under *Shari'ah* principles and can be done via a rebate provision at the time of debt maturity or via the willingness to accept losses (also known as haircuts)[145].

In summary, with the intent to develop a comprehensive *Shari'ah* based insolvency regime, Islamic finance jurisdictions must first and foremost recognize, as the UNCITRAL did, that the economic continuance of troubled yet viable businesses is significantly important, from a public policy perspective, as compared to the short-term maximum satisfaction of the businesses' debts[146].

3.4 Issues in the insolvency regime for the IFIs

One of the main pillars of Islamic finance is the profit and loss sharing concept. This risk absorbing concept is commensurate with the bail-in mechanism during resolution or insolvency proceedings (as opposed to the bail-out in which public funds are used to restore collapsed financial institutions). Hence, it is perceived that insolvency regimes can be easily applied in Islamic finance. However, there is further complexity embedded in the current status of Islamic finance operations. This includes (i) the large-scale usage of debt-based contracts in the Islamic banking operations; (ii) unclear and problematic assets transfer and ownership; and (iii) a lack of clarity regarding the instruments with the bail-in characteristic[147].

In the current Islamic finance practices, it is apparent that some insolvency issues have emerged, which may cause a delay in the development of a comprehensive *Shari'ah* based insolvency regime for IFIs. The following are some of the prevailing issues.

- Ambiguity and complexity with regard to Islamic finance product structure and documentation. This issue becomes even more complicated when courts apply secular law to define the contracting parties' legal rights. This will create additional burdens on the management pertaining to the legal risk in the IFIs[148]. Moreover, in some jurisdictions, the court will examine both the form as well as the substance of the transaction in order to ascertain its real legal nature[149].

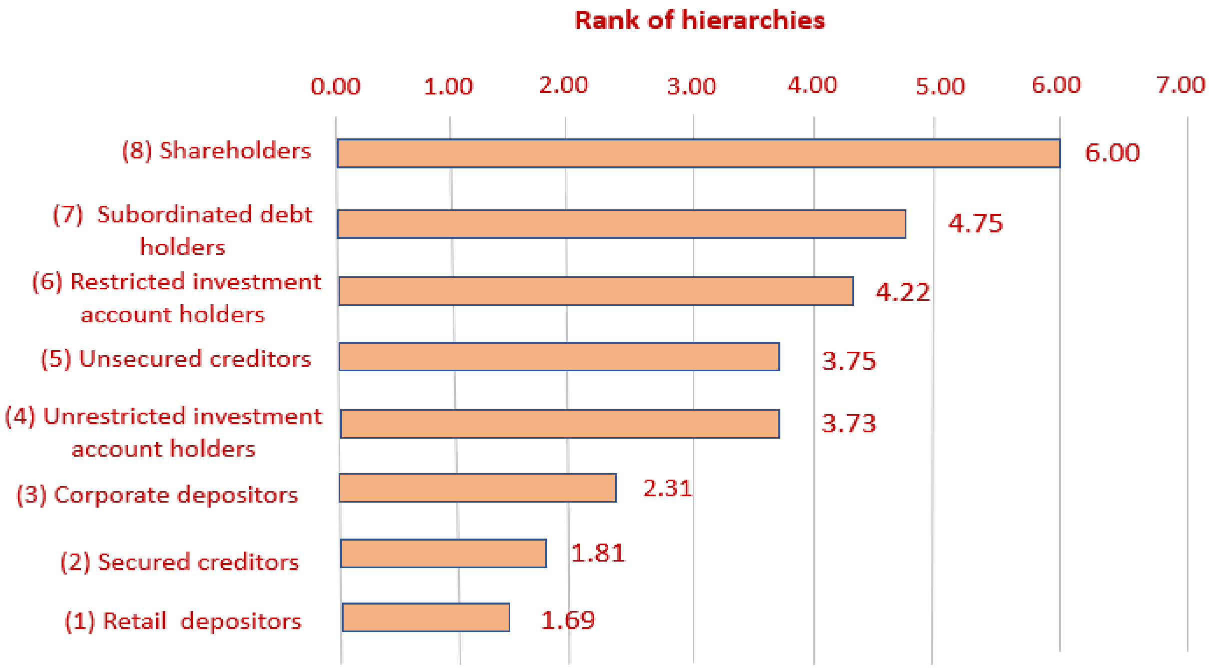
- The issue of recognition and enforcement of *Shari'ah* rulings. This issue arises, particularly in jurisdictions with secular legal systems where courts often interpret Islamic finance transactions in the context of their established legal frameworks[150]. Also, the lack of convergence of *Shari'ah* standards and the absence of harmonized *Shari'ah* rulings and principles among Islamic finance jurisdictions may oppose the legal status and distribution among investors and stakeholders in an insolvency event[151].
- The issue of the application of conventional insolvency regimes to Islamic finance. In this regard, the investment accounts would be an eligible example. From a *Shari'ah* compliance aspect, these accounts should absorb losses. However, from insolvency as well as financial stability perspectives, the supervisory authority dose not prefer depositors to bear such losses. This policy stance would be then reflected in the regulatory and legal framework. Another example would be the collective restructuring regimes in which the scheme forces a creditor, in some circumstances, against their will to adjust the terms of their debt arrangement, which is not permissible in *Shari'ah*[152]. Having said that, the purpose of Islamic law (*Maqaṣid al- Shari'ah*) allows for flexibility when it comes to the benefit of the society (i.e. restoring an entity back to its going concern status)[153].

Other insolvency issues involve the impermissibility of selling *Murabahah* receivables of a failing Islamic bank for an amount other than their face value under the resolution procedure[154]. Similarly, it is impermissible under *Shari'ah* rulings to unilaterally write down debt structures without the explicit consent of the *Sukuk* holders under a bail-in process. Furthermore, incorporating a write-down clause in *Sukuk* structures may still raise *Shari'ah* concerns[155].

With regards to the capital adequacy requirements, some Islamic finance jurisdictions (e.g. Malaysia) issued *Murabahah Sukuk* as Tier-2 capital, which incorporates a loss absorbency mechanism. This written stipulation in debt based *Sukuk* structure is tantamount to the prohibited combination of a loan and a sale contract in one single agreement[156].

Concerning the insolvency issues in the IFSI, it is worth mentioning that the IFSB conducted a survey in December 2016, wherein one part of the scope of the survey was to investigate how different banks rank the claims of different types of creditors, depositors and investors during an insolvency event. The survey sample included 18 RSAs of different jurisdictions.[157] The following chart further illustrates the survey outcome.

Chart (4) Rank of Hierarchies of the Creditors (No. 1 is the most protected claim)



Source: Adapted from IFSB, Stability Report 2018

The chart shows on average that retail depositor claims were the most protected category followed by secured creditors, while the shareholders ranked last with the lowest protection level among all depositors' claims. However, the average RSAs' responses surprisingly showed that the claims of unrestricted IAHs are more protected than the claims of unsecured creditors. They also showed that the claims of restricted IAHs are more protected than the claims of subordinated debt holders, which raises the issue of whether investment accounts represent liability or equity to IFI.

It is worth mentioning that PSIAs can be restricted or unrestricted; they are unrestricted when IAHs authorize the IFI to invest their funds without any restrictions. PSIAs could also be structured using *Mudarabah* partnership or *Wakalah* contracts. Besides, unrestricted PSIA funds are commingled with other depositor funds as well as shareholder funds; and they are reported as 'on balance sheet' items. Hence, unrestricted IAHs bear the risk of the general business of the IFI and, therefore, are treated as investors. Regarding restricted PSIAs, the IAHs impose restrictions as to where and how the funds are to be invested. Thus, restricted PSIAs are often registered as 'off balance sheet' items and bear the sole risk of their separately invested funds, therefore sharing some similarly with collective investment schemes.

As a result of that, since restricted and unrestricted PSIAs are not deposits, in resolution procedures, the claims of PSIAs would be less protection than creditors. Due to the equity nature of PSIAs, it is recommended to place unrestricted PSIAs in parallel with the shareholders, whereas restricted PSIAs should be in a standalone claims' hierarchy due to their off-balance sheet classification and their own risk profiles as well as its contractual terms.

3.5 An analysis of prominent high-profile Islamic finance default cases

The Islamic financial sector was negatively affected and incurred several cases of defaults amid the recent global financial crisis. In this regard, at least 15 Islamic finance default cases worldwide have been recorded up until the end of 2009. As for 2010, there were six new default events. In the same pattern, there were 24 registered default events in Malaysia between 2003 and 2010, according to RAM, the Malaysia rating agency[158]. The table below further illustrates the most prominent high-profile Islamic finance defaults, including nine default cases in the GCC region, and one Sukuk default case in the USA.

Table (3): List of prominent high-profile Islamic finance default cases

Default Case	Country	Date/year of default	Issuance Amount (000,000)	Underlying Structure	**Outcome of Resolution proceedings**
The Nakheel Group *Sukuk* (Dubai World**)**	UAE	November 2009	USD 3.520	*Ijarah* (sale and leaseback)	- On 14th December 2009, Dubai World received USD 4.1 billion as a bailout from the Emirate of Abu Dhabi. This amount was then used to repay its upcoming obligations including Nakheel *Sukuk*. - A default event has not been recorded as the repayment was made on the same day that *Sukuk* became due.
Dana Gas *Sukuk*	UAE	October 2012	USD 1.000	*Mudarabah*	- In December 2012, Dana Gas proposed a restructuring plan which was completed in May 2013. The plan included a cash payment of USD 70 million for *Sukuk* holders and the issuance of new *Sukuk* worth USD 850 million. This new issuance comprises USD 425 million ordinary *Sukuk* and USD 425 million convertible *Sukuk*, both due on 31 October 2017. - In June 2017, Dana Gas proposed a new *Sukuk* structure after its declaration that the outstanding USD 700 million *Sukuk* was no longer *Shari'ah* compliant. - In May 2018, an agreement was reached and in August, Dana Gas paid $235 million on redemptions and issued new *Sukuk* worth USD 530 million maturing in October 2020.
Tabreed 08 *Sukuk*	UAE	May 2010	USD 463	**Istisna'a* and *Ijarah*	-On 22nd May 2011, Tabreed, the Abu Dhabi-based utility company, announced the completion of the tender offer in relation to its 08 *Sukuk*. -Tabreed's tender offer for the 08 *Sukuk* formed a part of its recapitalization program, approved by its shareholders on 30th May 2010. -According to the Tender Offer Memorandum, the Mandatory Convertible *Sukuk* were exchanged for the company's shares at a price of AED1.1259 per share.
Gulf Holding Company (Villamar *Sukuk*)	Bahrain	2010	USD 190	*Musharakah*	-In February 2015, Bahrain-based Gulf Finance House (GFH) confirmed the signing of a financing agreement with Gulf Holding Company and Al-Rajhi Bank. The financing aims at completing Villamar Project and restructuring the existing *Sukuk* facility. -In October 2018, the GFH signed an agreement to acquire circa $200 million worth of Villamar sukuk from Al-Rajhi Bank.
Gulf Finance House (GFH) *Sukuk*	Bahrain	Not Stated	USD 200	*Ijarah*, *Istisna'a* and ***Murabahah*	-On 20th May 2012, GFH announced that it successfully obtained the approval of its *Sukuk* holders to restructure its outstanding debt. - On 15th May 2012, more than 92 percent of the Sukuk holders voted in an Extraordinary General Meeting in favor of the new restructuring terms.

* ***Istisna'a*** is a conditional sale contract whereby a party has undertaken a project or arranged for assets to be constructed or manufactured and has sold such a project or assets to a buyer on a deferred payment basis.

** ***Murabahah*** is sale contract whereby the purchase price is determined on a cost plus a predetermined profit basis. The price payment can be a lump sum or by deferred instalments.

					- According to the restructuring terms, The GFH *Sukuk* matured in June 2018 and provided GFH a 2-year grace period for the principal repayment amount in 2012 and 2013.
Arcapita Bank (syndicated facility)	Bahrain	2012	USD 1.100	*Murabahah*	- On 12th March 2012, Arcapita Bank filed for voluntary bankruptcy under chapter 11 of the US Bankruptcy Code. - In June 2013, the bankruptcy court approved Arcapita's reorganization plan. -On 17th September 2013, the reorganization plan was successfully completed. According to the plan, the company will gradually dispose of its assets over the subsequent 5 years. -The *Murabahah* syndicated facility providers shall recover an estimated 64% of their claims through the issuance of a new USD 550 million *Sukuk* facility. - The reorganized Arcapita Bank maintained its investment business and issued class A shares and new ordinary shares designed to repay its creditors.
International Investment Corporation (IIG) *Sukuk*	Kuwait	April 2010	USD 200	*Mudarabah*	- In September 2010, IIG's shareholders voted to reduce its capital by 55.8 percent to KD 20.2 million to cover losses. - Restructuring plan for a newly adjusted and manageable repayment schedule for *Sukuk* holders.
The Investment Dar (TID) *Sukuk*	Kuwait	May 2009	USD 250	*Musharakah*	-In January 2009, TID made a debt restructuring agreement with its creditors and investors. - In January 2011, an adjusted restructuring plan was agreed upon by both the creditors' committee and the shareholders. The approved plan included the repayment of the debt in tranches, the conversion of a proportion of debt into equity in the company, and a liquidity injection by the shareholders within a year.
Saad Group (Golden Belt 1 *Sukuk*)	Saudi Arabia	November 2009	USD650	*Ijarah*	-In May 2010, *Sukuk* holders exercised their right to dissolve the trust and voted for dissolution. Upon the dissolution, *sukuk* holders became unsecured creditors (no right for asset recourse). -The Government created a Royal Commission to restructure the Saad Group debt owed to Saudi lenders, while the right claimed by foreign investors remain uncertain. -On 10th November 2017, the Commercial Court of London released its judgment with regards to Case No: CL-2016-000622 (case for Golden Belt 1 *Sukuk* Company as claimant and Saad Group as defendant). -According to the summary judgment, Saad Group, the *Sukuk* originator, is liable to pay Golden Belt the sums of USD 668,271,643.19 plus £465,554.15. In addition, Mr. Al-Sanea who is the General Partner of Saad Group is also liable to pay Golden Belt the sums of USD 588,651,324.60 plus £465,554.14. Sums claimed against Saad Group and Mr. Al-Sanea are not cumulative. However, as of end of 2017, no steps have been taken to enforce this judgment in Saudi Arabia.
East Cameron Partners' *Sukuk*	USA	October 2008	USD 166	*Musharakah*	-East Cameron Partners Filed for Chapter 11 bankruptcy protection under the US Bankruptcy Code for a reorganization plan. -Subsequently, the Bankruptcy Court rejected the originator's request of re-categorization of the outstanding *Sukuk* as a secured loan facility. The court also upheld that Sukuk holders have a legal claim to the ownership of the underlying assets.

					-The next step in the reorganization plan involved the exchange of the Sukuk Certificates for common stock of newly formed companies (East Cameron Offshore Properties, Inc). -The *Sukuk* Certificates have been completely retired and the *Sukuk* Holders became common equity holders.

Source: *Sukuk* prospectuses, Offering Circulars, Reuters, Islamic finance News website, Tabreed Tender Offer Memorandum, twentyfoursevennews website, Bahrain bourse website, "Islamic Finance Insolvencies under Secular Bankruptcy Laws: A Case Study of Arcapita Bank under US Chapter 11", S&P Global, ISRA Commercial Report 2016, IFSB & World Bank.

The nature of default for the abovementioned *Sukuk* cases was mainly due to the global financial crisis and the liquidity shortage that hit almost all the economic sectors.

From a structural perspective, it can be observed from the table that most of the high-profile *Sukuk* defaults were structured using either a *Musharakah* or *Mudarabah* contract (five out of the ten cases). Both contracts are trust based partnership agreements in which profit is distributed according to a predetermined ratio and losses are borne on a pro rata basis in relation to the capital contribution. In other words, the venture underlying assets are maintained on a trust basis whereby none of the partners can be solely held liable for any losses except in a case of willful negligence, misconduct or breach of the terms of the agreement.

Default can be defined as the breach of contractual payment obligations when they fall due. From this straightforward definition, it can be argued that a default event becomes relevant only with debt-based contracts. Contrary to that, *Musharakah* or *Mudarabah* contracts have no contractually predetermined payment obligation. Therefore, these partnership contracts, by definition, cannot encounter a default event. Instead, the business venture can become insolvent once it is unable to maintain, on a going concern, its day-to-day operations. In this case, the business underlying assets could be sold, and the proceeds could be distributed among the partners pro rata to their respective capital contributions.

Moreover, *Musharakah* and *Mudarabah Sukuk*, also known as asset-backed *Sukuk*, are theoretically a bankruptcy remote securitization. This is mainly because of the restoration of the underlying assets to the *Sukuk* holders in case of the originator's default. However, from the practical aspect, this was not always the case when it comes to the resolution procedures adopted for the five mentioned *Sukuk* default cases. Which basically happened due to the non-payment of the periodic profit distributions. The resolution outcome may raise critical *Shari'ah* and legal concerns in terms of the proper documentation and the genuine implementation of profit and loss sharing contracts underlying the *Sukuk* structures.

Taking a closer look at the time frame of the resolution proceedings regarding the settlement of *Sukuk* default cases, it becomes apparent that most *Sukuk* restructurings have been ongoing for years. This time-consuming procedure is attributed to; (i) the complexity of Sukuk structures; (ii) a lack of legal certainty particularly in cross-border insolvencies; (iii) and a contractual unenforceability with respect to *Shari'ah* compliance issues. These factors all together will eventually result in complex negotiations and resolution proceedings for intermittent periods of time.

The implementation of Chapter 11 of the U.S Bankruptcy Code in terms of the reorganization and restructuring plans of two Islamic finance default cases (East Cameron and Arcapita Bank) was successful in many aspects, including *Shari'ah* compliance. These successful implementations can be viewed as the catalyst in considering Chapter 11 to be a foundation and a starting point in establishing an orderly Islamic finance insolvency and bankruptcy regime. This regime will enable *Shari'ah* compliant entities to purse their viable businesses while repaying creditors instead of undergoing liquidation. Moreover, the debtor-friendly background of Chapter 11 is in line with the *Shari'ah* rulings that recommend a distressed debtor be given respite until solvency can be achieved.

The following section will discuss the only two *Sukuk* default cases that occurred in Kuwait, namely the Investment Dar *Sukuk* (TID) and the Case for International Investment Group *Sukuk* (IIG).

3.6 An overview of the distressed Islamic financial instruments in Kuwait

The Kuwaiti financial sector, similar to that of other countries, was negatively affected by the recent global financial crisis. As a result, two cases of *Sukuk* default have been recorded. Fortunately, the IMF Multi-Country Report of 2017 assured that, thus far, no Kuwaiti Islamic bank has defaulted and, therefore, had to be resolved or liquidated.[159] The following is an illustration of the two *Sukuk* default cases.

3.6.1 The case for The Investment Dar (TID) *Sukuk* default

In 2009, the Kuwaiti financial market witnessed the first case of *Sukuk* default in the GCC region for The Investment Dar (TID), which is a Kuwaiti Islamic investment company. The primary reason behind its failure in meeting its debt obligations was the increasing cash-flow pressure and the constant depreciation of its asset-value during the financial crisis[160]. The company was unable to meet its debt obligations of approximately USD 3.5 billion. These debt obligations include two *Musharakah Sukuk* vehicles for a total amount of USD 250 million. The two *Sukuk* vehicles were issued in 2005 and 2006 for the amount of USD 100 million and USD 150 million, respectively[161].

Musharakah agreement of the *Sukuk* structure also contained an undertaking from the originator to repurchase the Special Purpose Vehicle (SPV) share in the underlying assets at the end of *Sukuk* period or upon any default or insolvency event. The TID effectively defaulted on the second *Sukuk* shortly after the default on the first one. Due to the liquidity problems and the default events, the TID made a debt restructuring agreement with its creditors and investors in January 2009, whereby the claims were to be temporarily frozen until March 2010[162]. In January 2011, an adjusted restructuring plan was agreed upon by both the creditors' committee and the shareholders. The approved plan included the repayment of the debt in tranches, the conversion of a proportion of debt into equity in the company, and a liquidity injection by the shareholders within a year. Subsequently, TID made its first payment of KD 82 million to its creditors two months ahead of the scheduled time of at the end of the year 2011[163].

An important lesson from this *Sukuk* default case is that investors are increasingly keen to see how effective the approach that the *Sukuk* originator adopts to solving such a default. Investors are also keen to see how *Shari'ah* rulings will protect their rights especially at times of dispute resolution[164]. Furthermore, Abdul Kadir Hussain, chief executive at Mashreq Capital, highlights the importance of successful recovery and restructuring procedures. He also asserts that it will eventually set the benchmark for how investors assess the risk of *Sukuk* default. Likewise, Moody's Rating Agency has pointed out that *Sukuk* are being examined for the first time in terms of the originator insolvencies since the financial crisis and how restructuring remedies have been initiated and monitored[165].

3.6.2 The Case for International Investment Group (IIG) *Mudarabah Sukuk*

The other Kuwaiti based *Sukuk* default was by the IIG, which is a *Shari'ah* compliant investment company that was licensed by the CBK. This *Sukuk* default occurred in 2009, when IIG defaulted on *Sukuk* worth USD 200 million[166].

In 2007, the IIG Funding Limited, which was a SPV and the Trustee of the *Sukuk* vehicle established in Jersey, issued a USD 200 million exchangeable *Mudarabah* based *Sukuk*, which was listed on the Dubai International Financial Exchange (DIFX). These *Sukuk* instruments were changeable into IIG shares under predetermined circumstances[167]. Furthermore, the IIG *Sukuk*, which was scheduled to mature on July 10th, 2012, had a limited recourse, and were not the debt obligations of the issuer. In other words, the *Sukuk* certificates did not represent bonds or notes issued by the issuer; instead, the certificates represented entitlements solely to the underlying assets (or assets held by the Trustee)[168].

Due to the recent global financial crisis, IIG had accumulated losses of USD 142.9 million by the end of 2009[169]. Subsequently, on April 12, 2010, IIG had declared its inability to make the periodic distribution amount of USD 3.35 million due to its *Sukuk* holders[170]. By July of that year, IIG had announced its inability to pay the amount of USD 152.5 million to its *Sukuk* holders, who requested immediate repayment after the default in April. Subsequent to that, in September 2010, IIG's shareholders voted to reduce its capital by 55.8 percent to KD 20.2 million to cover losses. The company also hired KPMG consultancy company to review its business and suggest appropriate restructuring mechanisms. The consultancy company recommended a range of options for IIG's restructuring, which included selling assets, finding new investors or dissolving the company[171]. IIG chose the restructuring strategy for its *Sukuk* default, with a newly adjusted and manageable repayment schedule [172].

In light of that, the slowdown in the Kuwaiti *Sukuk* market since the downturn is often attributed to the lack of a specialized legal framework for *Sukuk* issuance. As such, the regulation issued by the Capital Market Authority of Kuwait (CMA) in November 2015 was widely considered to be a positive step forward. The rules include the structures, governance and *Shari'ah* compliance of *Sukuk* issuances[173].

3.7 Developing an effective insolvency and liquidation regimes for IFIs

The recent global financial crisis witnessed a few default cases of Islamic financial instruments. These events have clearly illustrated the need for an effective insolvency system for IFIs, which is not only in line with the *Shari'ah* principles but also is appropriately benchmarked against international best practices to gain global acceptance among the IFSI stakeholders. Furthermore, having in place a well-designed insolvency regime for IFIs will help to restore troubled yet viable Islamic financial institutions or instruments. It will also enable the reallocation of financial resources to more functional institutions and market users through liquidation proceedings. This mechanism will foster the safety and stability of the IFSI and smoothen their integration within the global financial system.

In this regard, an essential first step for the development of such an insolvency regime for IFIs will be an assessment of the applicability of internationally recognized insolvency regimes to the Islamic financial sector. Such prominent regimes would be the previously discussed UNICTRAL legislative guide on insolvency law as well as the World Bank Principles for effective insolvency and creditor rights systems. These guidelines and principles will help facilitate the establishment of an effective insolvency regime for IFIs. Nonetheless, there will be areas where adaptation will be required to reflect the unique characteristics of Islamic finance and the relationship between the IFIs and their stakeholders[174]. In the same pattern, the IFSB and the World Bank held a roundtable conference in October 2010 to discuss the way forward to develop an effective insolvency regime for IFSI. The roundtable recommendations revolved around the revision of the various cases where the restructuring of Islamic finance transactions had taken place during insolvency situations. The roundtable also highlighted the importance and impact of dispute resolution mechanisms in insolvency concerns[175].

From a cross border perspective, it became a prerequisite to put in place a *Shari'ah*-based cross border insolvency regime to handle the consistent increase in Islamic financial transactions. Hence, it is inevitable to encounter international insolvency issues in the Islamic financial industry. For that purpose, a range of international initiatives pertaining to insolvency regimes (e.g., the UNCITRAL Model Law on Cross Border Insolvency and the EU Bank Insolvency Directive) can be adopted and adapted for the development of an effective international insolvency regime for IFIs. It will further enhance coordination and cooperation among Islamic finance jurisdictions as well as ensure fair resolution proceedings of Islamic finance insolvency related cases[176].

The following points are the key aspects that should be taken into consideration while developing an effective *Shari'ah*-based insolvency regime:

- A *Shari'ah* compliant bail-in mechanism should be incorporated as part of the design of the insolvency regime. This can be achieved by considering the stipulation of bail-in powers in the structures of Islamic finance contracts (the so-called contractual bail-in approach), hence, making the stipulation equivalent to a voluntary debt forgiveness by the creditors under such agreements[177].
- The establishment of *Shari'ah*-based out-of-court resolution alternatives including restructure and reorganization. This key aspect is becoming more importance due to the fact that many Islamic finance restructuring cases are consensually taking place out of court.
- The confusion and ambiguity that followed some of the *Sukuk* defaults or nearly default cases in the past need to be adequately addressed. Also, investors' rights, especially in asset based *Sukuk* structures, following insolvency and restructuring, need to be preserved. Often, investors have no right to the *Sukuk*'s underlying assets during a

default or insolvency event despite the fact that they own those assets at the outset of *Sukuk* issuance[178].

- Islamic finance products should be well drafted to clarify the rights and obligations of the contracting parties and eliminate any potential conflict between the substance and the form. Having in place a centralized *Shari'ah* board (comprised of knowledgeable *Shari'ah* scholars, lawyers, accountants, expert bankers and economists) at the central bank level will potentially mitigate these anomalies and drive the convergence between the form and substance in Islamic finance contractual agreements[179].

In short, a comprehensive insolvency regime for IFIs should incorporate both *Shari'ah* insolvency-related principles as well as *Shari'ah* regulations and accountability (*Hisba*) which means market conduct and regulation. This desired combination will eventually meet the policy and supervisory direction and public objectives. Furthermore, the main regulatory and supervisory objectives from the *Shari'ah* perspective are consumer protection, market stability, and the preservation of stakeholders' rights. Therefore, *Shari'ah* market regulation or *Hisba* should be an integral part of the formulation of the insolvency and liquidation regimes for IFIs[180].

Section 4: Conclusion and Recommendation

The recent global financial crisis provided significant regulatory lessons for policymakers with regards to the importance of a comprehensive financial safety net in enhancing the resilience and stability of the financial and economic sectors. This safety net comprises of a robust insolvency and resolution regime, LOLR facility as well as DIS. Furthermore, due to the size and the systemic importance of the IFSI, this paper highlights the urgent need to establish a well-functioning SDIS as well as a SLOLR facility. This insurance scheme should have a broader mandate in addition to its depositors' payment objective (other mandates may include restructuring and reorganization of distressed IFIs). Besides, the SLOLR will play a crucial role in providing liquidity for illiquid yet solvent IFIs, particularly during severe liquidity distress periods.

This research paper also emphasizes the importance of an adequate stakeholders' protection framework for IFIs, covering the three main components of the Islamic financial sector, namely, the Islamic banking segment, the Islamic insurance segment, and the Islamic capital market segment. The paper then reiterates the prudential and supervisory objectives of stress testing for IFIs covering the overall major risk categories, including unique risks in the IFSI. Moreover, the stress testing framework should be in the form of a joint stress testing of solvency and liquidity.

The findings show the benefit of an effective insolvency and creditor/debtor rights regime in terms of facilitating credit extension, stimulating private sector development and boosting the economic growth. It also enables the troubled yet viable businesses to continue as ongoing concerns while dissolving those that cause public panic and threaten financial stability.

Based on the aforementioned issues and challenges, the paper suggests the following recommendations for the development of an effective Islamic financial safety net:

- **A gradual dismantling and replacement of the blanket (full protection) SDIS** (e.g. the case of Kuwait). This important shift into a limited protection SDIS can mitigate the moral hazard among the IFIs and encourage best market practices. The SDIS should also obtain a broader mandate, with various alternative measures in the insolvency proceedings (e.g., the role of liquidity and capital providers for restructuring and reorganization procedures).
- **In the same context, moving to a limited protection SDIS requires some clarification on how to incorporate the PSIAs into the insurance protection scheme**. It also needs to identify how different dispositors are ranked against each other, and how restricted and unrestricted PSIAs are ranked within the SDIS depending on their *Shari'ah* compliance terms and structures as well as their risk profile.
- **The incorporation of international cross board insolvency regimes.** This includes the UNCITRAL Model Law on Cross-Border Insolvency, the EU Bank Insolvency Directive, and the IMF Resolution of Cross-Border Banks proposed framework. Such regimes could be applied as benchmarks and best practice for the development of a harmonized international (or a regional) insolvency regime for IFIs. This will help improve coordination among different Islamic finance jurisdictions and ensure fair resolution proceedings for Islamic finance cross border transactions.

- **An inclusive IAHs protection framework is also a pivotal component of an effective Islamic finance protection framework**. This IAHs protection framework should; (i) provide legal and regulatory clarity for PSIAs; (ii) enhance accounting treatment and financial disclosure requirements for PSIAs; (iii) clarify the treatment within the contractual agreements of PSIAs in insolvency situations and their claims' hierarchy vis-à-vis other stakeholders; (iv) establish a representative committee that protect the IAHs' rights in the IFI. There also should be a contractual insertion that gives IAHs the sole right of recourse to their restricted *Mudarabah* funds and to transfer them to a suitable new *Muḍarib* in the event of insolvency.

- **The need for efficient *Shari'ah* and legal frameworks**. In this regard, it is highly recommended to examine the feasibility and applicability of the possible implementation of the successful Malaysian *Shari'ah* regulatory framework. Also, having a central *Shari'ah* board in the central bank helps mitigate the legal risks in Islamic finance markets and enhance the enforceability of Islamic finance contracts. The Malaysian Islamic Financial Service Act (IFSA) 2013 clearly states the role of the *Shari'ah* Advisory Council of the central bank in dispute resolution and the enforcement of Islamic finance contracts.

- **Establishing a central *Shari'ah* board at the Capital Market Authority level** for the purpose of enhancing market confidence, especially towards *Sukuk* instruments. The board can provide timely assurance with regards to the compliance with the *Shari'ah* principles and prevent *Shari'ah* non-compliance, especially in the case of *Sukuk* defaults.

- **The importance of establishing a time-effective, standalone *Sukuk* default resolution regime**. This regime should cover both the domestic as well as the cross-border level. It should therefore, protect international investors' rights and facilitate quick and smooth resolution procedures. In this regard, chapter 11, also known as reorganization and restructuring bankruptcy, can be a starting point as it has proven to adopt an economic substance approach which does not contradict *Shari'ah* rulings and principles. However, a proper scrutiny of chapter 11 must be performed in all aspects (i.e. legal, *Shari'ah*) in order to assess its appropriateness for the Islamic finance principles and objectives.

- **The establishment of a special *Sukuk* bankruptcy court can be a valuable initiative among the GCC countries and other Islamic finance jurisdictions.** By implementing a built-in contractual dispute resolution mechanism rather than splitting the governing law between the domestic law and the English law, there will be a time efficient and transparent *Sukuk* resolution procedure particularly with regards to cross border *Sukuk* defaults.

- **The need of an adequately and clearly drafted and standardized documentation for Islamic finance products.** Such documentation should consider insolvency/default events and provide the appropriate insolvency mechanisms (e.g. restructuring and reorganization). This step will eventually reduce the complexity within the Islamic finance product structures. It will also effectively mitigate the legal risk and avoid potential conflict between the substance and the form of the contractual agreements (e.g. IIG *Sukuk* and the issue of insolvency/default in a partnership-based agreement) and the ways to determine the event of negligence or misconduct by the *Mudarib*.

- **The need to standardize the legal and regulatory frameworks as well as the *Shari'ah* rulings across countries**. This initiative can be implemented among the GCC countries. This will help to reduce the unfair interpretations of governing laws, and unequal treatment in resolution proceedings towards foreign investors in Islamic finance cross border defaults.

- **The importance of having experienced insolvency professionals with Islamic law background.** These professionals should be capable of ensuring the effective implementation of the insolvency regime for Islamic finance. In this regard, the International Association of Insolvency Regulator (IAIR) principles can also be implemented in Islamic finance jurisdictions in order to qualify more human capital in the field of insolvency.

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