Islamic Finance and Insolvency: An Overview of Related Literature

**Dr. Syed Naeem Badshah*
***Dr Najeeb Zada*

Abstract:

Islamic finance has made great progress during the past two decades. Its growth has been recognized and witnessed in both Muslim and non-Muslim majority countries. Its performance and relative resilience during the global financial crisis particularly attracted the attention of regulators, financial institutions, and general masses towards this emerging segment of the conventional financial system. However, since Islamic finance is still at its nascent stage of development with compared to its conventional peer, there are many unsettled issues which are not resolved yet. One such issue is the question of insolvency and bankruptcy. While conventional financial system has witnessed many episodes of insolvency and default throughout its history, there is a proper mechanism in place to address this issue. But this is not the case with Islamic finance as we have yet to witness a system wide wave of distress where one can observe the response of the industry to such shock as well as the effectiveness of the measures taken to face such a challenge. Due to this situation, there are a number of issues which need to be addressed and questions that need to be answered when it comes to the matter of default, insolvency and bankruptcy in Islamic finance. In this article, we aim to present a review of the related literature which has discussed the question of insolvency and default in the context of Islamic finance. We find that most of the studies have confirmed that literature in the area is very scarce and further exploration of this area is very much needed. In addition, it is also recognized in the relevant literature that the classical Islamic law has rich sources that can be looked at and utilized for effectively addressing many of these challenges and issues of contemporary Islamic finance.

Key Words: *Insolvency, default, Islamic finance, Shariah, hadith, sukuk*

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* Chairman Department of Islamic / Pak- Studies, Agriculture University Peshawar.
**Lecturer, Department of Islamic Theology, Islamia College Peshawar

Introduction

The relative resilience of Islamic finance during the recent global financial crisis is well evidenced in the literature. It is supported by common sense too since no Islamic financial institution is known to have been bankrupt during the crisis. However, it is admitted simultaneously that Islamic finance industry in not resilient to shocks by its nature. Furthermore, it is universally accepted that banks fail from time to time, and eventually an Islamic bank will fail too. This prospect of an Islamic bank going bankrupt in the future raises important questions because the bulk of Islamic banking is a voyage into the realm of unknown, including the consequences of a downfall. This was partly evidenced as many new challenges were encountered when some *sukuk* failed in the wake of the global financial crisis. Therefore, it is timely to address the concerns and questions that will arise when an Islamic financial institution goes practically bankrupt.

The need to address insolvency and bankruptcy[1] in the context of Islamic finance is specially highlighted in the post global financial crisis literature. Even before the crisis, concerns existed due the replacement of equity-based Islamic banking model with the debt based banking structure, albeit via Shariah[2] compliant contracts. *Murābaḥah* became the dominant activity of Islamic banks and debt, therefore, came to assume a greater role than was initially anticipated. Still, mainly due to its short history, modern Islamic finance paid little attention to insolvency and its consequences. But as the global financial crisis deepened and its effects reached the real sector of the economy, questions were raised as to how the existing bankruptcy and insolvency regimes, both in and outside the Muslim countries, will address Shariah compliant transactions in the case of insolvency? The issue was further highlighted by instances of *sukuk* failures and quasi-failures, which brought to the fore matters of insolvency and bankruptcy in relation to Islamic financial institutions.

Thus, it should not come as a surprise that institutions like World Bank, Islamic Financial Services Board (IFSB), Accounting and Auditing Organization for Islamic

[1] The terms insolvency, bankruptcy and default are used interchangeably in this paper.
[2] The word Shariah is used interchangeably with the term Islamic law throughout this research.

Financial Institutions (AAOIFI) and the *Fiqh* Academy of the Organization of Islamic Cooperation (OIC) have addressed this issue in the wake of global financial crisis. Although the literature on this issue is scarce, the discussions by these institutions have produced some good food for thought and further research. Consequently, researches have been undertaken to evaluate different aspects of this topic. Though the progress of the research is currently slow, it is expected to gain momentum with the passage of time.

With the above background, the current research is an effort to summarize the recent literature on Islamic law of insolvency. The existing literature on this issue has highlighted some pressing Shariah issues that will hamper the smooth bankruptcy proceedings. For instance, the very notions of legal personality and limited liability, especially the later of these two, is contested among Shariah scholars. But these two concepts lay at the core this whole debate. Moving ahead, there are unresolved issues like voluntary insolvency, corporate bankruptcy, acceleration of debts, debt discharge, creditors' hierarchy, claw-back actions, reorganization and bankruptcy claims trading, to mention a few, which need to be resolved according to the Shariah principles.

The Need for Effective Insolvency Law

The argument of multiple creditors is presented as the standard logic for the need of bankruptcy laws. Usually, a debtor has obligations to more than one creditor and without standard bankruptcy laws creditors might be motivated to "run on assets" because the assets of a firm may not be sufficient to cover all its creditors' claims (Kolecek, 2006).[1] Consequently, there is a need for effective insolvency regime, i.e. an efficient regulatory, legal and supervisory treatment of the insolvency and bankruptcy of corporate entities in general and financial intermediaries in a way that the rights and obligations of all the stakeholders are clearly distinguished and catered for. However, insolvency laws are under greater scrutiny than before as governments and legislators seek to mitigate the effects of the global financial crisis on both businesses and individual consumers. While some insolvency laws have been comprehensively overhauled, others have introduced new procedures or have been subjected to important amendments, especially with a view to encouraging business rescue. International financial institutions like International Monetary Fund and the

World Bank are seriously involved in this process of overhauling. In some cases, like that of Portugal and Ireland, these institutions have made financial assistance conditional upon insolvency law reform by the respective government (Bridge, 2013).[2] The concern of these institutions is justified since it is ineffective insolvency regime that is often mentioned as the reason of deepness for financial crises. It was the absence of an appropriate bankruptcy regime in the East Asian countries that considerably complicated the process of corporate restructuring after the East Asian financial crisis 1997-1998 (see for instance: Stiglitz (2001)[3]). Thus, effective insolvency regime is a means of minimizing the negative impact of crises on financial markets.

Islamic financial intermediaries operate as a part, albeit a tiny one, of the overall global financial market. One of the most pressing and crucial problems in the development of financial markets is the regulatory treatment of the insolvency of financial intermediaries (Garrido, 2010)[4] which also includes those intermediaries which operate as per Shariah principles. Such intermediaries are not immune to shocks by nature and are, therefore, in need of effective insolvency laws like their conventional counterparts. Tata (2012)[5] notes that the topic of insolvency regime for Islamic finance industry needs to be addressed in order to: "achieve the integration of Islamic finance into the global financial system" (p. 2). This need has also been realized by the international financial organizations which look at Islamic finance as an alternative and compatible form of financial intermediation. And the call for such a regime has been timely made by institutions like Islamic Financial Services Board and World Bank (2011)[6] which concluded one of their roundtable discussions on the topic of insolvency regimes for Islamic finance with these apt remark: "Although there were no known cases of Islamic banks experiencing insolvency during the last financial crises, discussions of this issue need to be initiated as a matter of foresight in order to prevent complex situations arising in the future." (p. 135) Thus, it safe to conclude that the financial crisis of 2007-2008 is the key driver for the attention paid to and interest taken in the issue of insolvency and bankruptcy regime for Islamic finance industry. Accordingly, the literature available on this issue is both scant and updated at the same time.

Literature on Islamic Insolvency Law in the Context of Islamic Finance

A seminal work on Islamic principles of insolvency has been conducted by Kilborn. In one of his papers, Kilborn (2011)[7] has carried an in depth analysis of the theoretical foundations of forgiveness, charity and similar aspects of Islamic law with respect to a distressed debtor. In his study, the writer has initiated the discussion with an analysis of Quranic verses relevant to bankruptcy. He then looks into the *hadith* literature and discusses different traditions from the Prophet Muhammad peace be upon him, as reported by Imam Muslim, Imam al-Tirmizi and Imam Abu Dawud etc. Afterwards, the writer meticulously explains some basic terminologies of both Islamic and conventional laws, like *iʿsaar, ʿusr, iflas, taflis,* balance sheet insolvency, and income statement insolvency etc. According to the writer, a thorough review of Quran, *hadith* and Islamic jurisprudence shows that a creditor is morally obliged to give time and, if possible, rebate to the debtor who is in distress. However, the legal aspect of Islamic law shows that debtor has, at any cost, the liability to pay the debt as long as she is alive. The writer also finds it interesting that a debtor is among the recipients of *zakat* which leads him to conclude that Islamic law has a soft corner for distressed debtors.

Awad and Michael (2010)[8] have addressed Islamic insolvency law from a comparative legal perspective by discussing the Islamic viewpoint on insolvency putting it parallel to Chapter 11 of the United States which deals with corporate bankruptcies. The writers conclude that in spite of similarities between Islamic law and Chapter 11, there are sharp contrasts between the two which demands that this issue be timely addressed before the actual insolvency situation of an Islamic financial institution is faced. During their discourse, the writers have highlighted some fundamental issues related to Islamic law of insolvency including the hierarchy of creditors, the issues of separate legal entity in Islamic law as well as the issues that might arise while establishing a modern version of Islamic insolvency law for current day Islamic financial institutions. However, this paper only focuses on the Maliki viewpoint using a single book written by ibn Qudamah as a source. A holistic approach focusing on all the four Schools, or at least majority of them, would have made this paper much convincing.

Kilborn (2011a)[9] is fascinated by the insolvency and bankruptcy related examples and precedents as found in the two original sources of Shariah: "Alongside the Qur'an, the other primary source of Islamic law is the example or tradition (*sunnah*) of the Prophet Muhammad, which also contains several striking bankruptcy-related precedents" (Kilborn, 2011a, para. 5). After quoting one such precedent from *hadith* literature, the writer concludes convincingly that the classical Islamic law of insolvency was quite sophisticated: "On the basis of these and other fleeting but explicit references to financial distress in the primary sources, medieval Islamic legal scholars elaborated a relatively sophisticated body of insolvency law." (ibid, para. 6)

Kilborn (2011)[10] makes some interesting observations regarding the implementation of Islamic law of insolvency in the modern day Islamic finance. For instance, discharge of debt through court is not possible under the classical Islamic law. There is a famous *hadith* narrated by Imam Muslim in which the Prophet peace be upon him asked the creditors to take only what they find with the distressed debtor by stating: "Take what you find and you will have nothing beyond that." (Kilborn, 2011, p. 334)[11] According to the writer, this *hadith* has been interpreted by the Muslim scholars to mean that the creditors do not have any right *at this moment* over and above what they find with the debtor. However, they will be entitled to whatever the debtor earns "in the future" with certain restrictions. This *hadith* stands in sharp contrast to the current day debt discharge powers of the courts. Furthermore, the writer also raises the issues of voluntary bankruptcy, legal entity, priorities of creditors etc. that will be challenging in the implementation of Islamic insolvency law in the context of modern Islamic finance.

Some aspects of Islamic insolvency law have been addressed by Hamoudi (2011)[12] who laments that this issue has not been sufficiently addressed by the Islamic finance industry. He attributes this lack of interest to two reasons. Firstly, the trend in Islamic finance industry so far is to legitimize things instead of recourse to the implementation of classical Islamic law. This is why "Shariah compliant" and "Shariah based" distinction is found in Islamic finance. Secondly, the "choice of the law clause" has been extensively used in complex situations, especially in non-Muslim jurisdictions, in order to abide by the law of the land and overrule Islamic

law. This approach is less costly as well as convenient and more acceptable in the current globalized Islamic finance industry. But the writer insists that the topic of insolvency needs immediate attention due to the credit driven nature of Islamic finance industry. The writer also claims that Islamic law of insolvency has to be taken in its classical form since a compliant version of this law cannot be formed. The diversity in insolvency laws across jurisdictions is why a "globally compliant" version of Islamic insolvency law is not possible.

McMillan (2012)[13] has thoroughly investigated the issue of East Cameron *sukuk* insolvency and its subsequent court proceedings and has come up with some interesting observations. Accordingly, the writer questions: what is the stance of Shariah about a non-compliant transaction taken initially to achieve compliance with Shariah at some later stage? Furthermore, the writer explains different mechanisms of the US bankruptcy law, like Chapter 11, reorganization and debtor in possession (DIP) financing. In addition, like Kilborn (2011)[14], McMillan also discusses the primary issues related to the topic of insolvency in Islamic law, like the theoretical foundations of insolvency in the sources of Shariah, the basic notions of *iflas* and *iʿsar*, as well as the concepts of balance sheet and income statement insolvencies.

Some of the literature relevant to Islamic insolvency law focuses on practical aspects of Islamic banks to highlight some challenges. For instance, the unique relationship of Islamic banks with their customers and the unique features of contracts utilized by Islamic banks are analyzed by Wong and Seward (2011).[15] To illustrate the writers' argument, *mudharabah* deposits are one unresolved issue till today. Specifically, the regulators are not yet conclusive regarding the treatment of unrestricted *mudharabah* accounts as deposits or investments. Consequently, these funds do not seem to fit anywhere in the accounts of Islamic banks. Thus, it will be interesting to see how this account is treated in the case of insolvency and bankruptcy of an Islamic bank. The writers also draw a "simplified balance sheet" for Islamic banks and conclude that the legal relationship between Islamic banks and their customers is drastically different from the relationship between conventional banks and their clients, i.e. a borrower lender relationship. Hussain (2011)[16] focuses on the issue of *murabahah* portfolio of an Islamic bank and highlights its challenges. *Murabahah* constitutes the bulk of

Islamic banking today. However, it may also be an impediment in the smooth insolvency procedures of an Islamic bank. This is because a *murabahah* contract usually expands over many years. In this situation, if the bankruptcy proceeding of an Islamic bank initiate and the *murabahah* portfolio is not yet mature, it will definitely impact the smooth bankruptcy proceedings since payment to creditors and depositors of the bank will not be possible before maturity.

Furthermore, Mahmood and Kamil (2011)[17] elaborate that the term "insolvency" can refer to insolvency from accounting, corporate law or Islamic law perspective, each one with unique features and detail. The writers conclude that the contracts used by Islamic banks are different from the simple borrowing/lending contract of conventional banking institutions. Referring to a Quranic verse (2:280), the writers argue that this verse offers some potential solutions to the problem of insolvency, like debt restructuring through time extensions, debt restructuring through a new contract and application of rebates or "haircuts". Shariah may allow haircuts in the form of "*ibra*", "*tanazul*" and "*iqalah*" (p. 53).

The bankruptcy of Arcapita Bank under the US Chapter 11 has been analysed by Zada et al. (2017).[18] The writers have concluded from the analysis that the US Chapter 11 can potentially be used as a model to create insolvency regime for Islamic finance. However, there will be certain amendments needed in it to cater for the needs of Islamic finance industry. Similarly, the writers discuss the possibility of a Shariah compliant debtor in possession (DIP) facility. In another study, Zada and Muhammad (2018)[19] have also analysed the recent case of Dana gas *sukuk* default and discussed the difficulties faced in the resolution of Islamic finance disputes particularly when a case is brought in two different jurisdictions at the same time.

Abdelhady (2013)[20] has called for establishing specific insolvency regime for Islamic banks since they are different from conventional banks. As an illustration, the writer discusses the profit sharing investment account (PSIA) to show the uncertainty surrounding many aspects of Islamic banks in the case of insolvency. The regulatory classification of PSIA varies across jurisdictions. It is classified only for regulatory purposes in Dubai International Financial Centre. In contrast, the banks in Europe offering PSIA treat it as deposits. Similarly, the Bahrain based Accounting and

Auditing Organization for Islamic Financial Institutions (AAOIFI) describes it as "demand deposits" in one of its standards but stresses the role of *mudharib* in another. This leads the writer to conclude that, in such uncertain situation, interested parties need to undertake a collaborative process to develop and implement an insolvency regime for Islamic banks, rather than to bear the costs of poorly managed bank failures in the future.

Conclusion:

The analysis in this paper shows that the existing literature on insolvency and default in the context of Islamic finance can be broadly divided into three types. First, there are studies which focus on theoretical aspects like legal personality, limited liability and the like. Second, some studies also discuss practical issues like the treatment of profit sharing account. Last, there are studies that deal with the different case studies pertaining to default in the context of Islamic finance. What is further clear from these studies is that the issue is emerging one which means that much needs to be done in this area. Also, there is a call for addressing this issue on urgent basis. Additionally, different proposals like using Chapter 11 as a possible ground for addressing corporate bankruptcy in Islamic finance have also been discussed. Moving forward, it is recommended that researchers should devout greater efforts to explore this emerging area. It is further suggested to focus more on the practical aspects of this issue. Particularly, the actual cases of default in this regard can be taken as the starting point to have an idea of the diverse issues and then solution should be designed on the basis of the existing practical examples.

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