



# In search of sharia-compliant resolution framework for Islamic banks: The case of Indonesia

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## Abstract

**Purpose** – This paper investigates Sharia concerns on existing bank resolution framework and propose recommendations on how to resolve those concerns in Sharia-compliant manners. It also assesses compatibility of resolution powers mandated by the FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions if applied to resolve failed Islamic bank, especially focusing on operational aspect of executing the resolution options.

**Methodology** – We conduct a series of focus group discussion with various relevant stakeholders, including Indonesian Sharia scholars, regulators, professional associations, Islamic bankers and academics. The discussions were performed in group interviews format, with the authors took part as moderators. The discussions took place between July 2020 to January 2021, and were part of development of fatwa and regulations on the resolution for Islamic banks.

**Findings** – In general, the existing bank resolution framework can be applied to Islamic banks. However, there are some resolution powers of the authority that possesses inherent sharia issues, but are still allowed according to Dewan Syariah Nasional (DSN) (the National Sharia Council). There should be clear measures attached to those powers prior to implementation. For some aspects, some adjustments to the resolution powers are also needed through establishment of infrastructures and regulations, particularly with regards to resolution options.

**Originality** – The novelty of this study is the analysis of suitability of banking resolution issues from Sharia perspective. This paper also serves to enhance awareness on issues related to resolution of Islamic banks and promote wider implementation of Sharia approaches for bank resolution in other jurisdictions.

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## Introduction

Bank resolution has become one of the most important topics in the area of financial stability, particularly after the global financial crisis of 2008. It is even more pronounced during the Covid-19 pandemic, which sees additional factors contributing to the risks encountered by the banks. In the realm of Indonesian Islamic banking, the uncertainty brought about by the adverse events (could be brought about by pandemic, crisis, war, etc.) expose Islamic banks to increased liquidity risk (Anis & Hamdi, 2022) and capital, asset quality, and earnings (Muhammad & Triharyono,

2019). Especially during the recent pandemic, such events could also cause the efficiency of Islamic banks to decrease (Ikhwan & Riani, 2022).

Various experiences of financial crisis taught us that ineffective handling of bank failures could trigger systemic risk, or at least lead another bank to experience difficulties, either due to interconnectedness among the banks, or due to panic as result of bank liquidation. To mitigate the ineffective policy in handling bank failures, Financial Stability Board (FSB) issued a guidance called the Key Attributes of Effective Resolution Regimes for Financial Institution (The Key Attributes). The Key Attributes set out the core elements that the FSB considers to be necessary for an effective resolution regime (Financial Stability Board, 2014).

Although comprehensive bank resolution framework such as the Key Attributes has been provided for banking industry, how the framework shall be implemented to Islamic banks is still questioned. One of the papers posing this question is Awadzi et al. (2015), which raise a number of issues around the topic of Islamic bank resolution that need to be addressed, considering the unique features of such banks. Therefore, they suggest jurisdictions where Islamic banks operate to establish robust resolution frameworks that are also in line with sharia rules and principles (Awadzi et al., 2015). Unfortunately, research in the area of Islamic bank resolution is very limited. Previous studies on insolvency and resolution of Islamic banks focus more on the failure of Islamic financial transactions, particularly sukuk rather than the institutions themselves (McMillen, 2012).

Providing guidance on sharia approach in resolution for Islamic bank is very important for jurisdictions with Islamic banking industry. Not only because a failure of systemic-level Islamic bank can trigger banking crisis, but also because in the jurisdictions with small Islamic banking industry, the possibility to have high interconnectivity among Islamic banks is very likely. Failure of an Islamic bank may lead to series of failures of other Islamic banks due to them being highly interconnected. If the resolution of Islamic banks is not well handled, the stability of Islamic banking industry will potentially be harmed.

Nevertheless, providing adequate sharia-compliant resolution framework is not merely a financial stability issue. Effective resolution regime promotes market confidence, which is in part influenced by customer protection. Thus, customer protection is also an essential issue that should be a concern of resolution authority in resolving bank failures. Issues on customer protection is very relevant in the case of resolution of Islamic bank. If not well observed in the resolution of Islamic bank, the unique features of its products can jeopardize customer rights. This may lead to dispute resolution between the resolution authority and the customers of the Islamic bank in resolution. This condition might disturb the effectiveness the resolution process.

Fortunately, Islamic bank failure is a relatively rare occasion. Some failures of Islamic banks, such as Ihlas Finans in 2001 and Bank Asya in 2015 in Turkey, which were resolved under corporate insolvency law, did not disturb market confidence for Islamic banking in Turkey. Similarly, the failures of 10 Islamic banks in Indonesia did not significantly affect the stability of Islamic banking industry in the country. This is because all such banks were Islamic rural bank operating in only limited area in Indonesia, which were relatively small in size. Nevertheless, during and after the resolution process, a lot of questions surfaced, particularly on how those banks initially should have been resolved. On this aspect, the resolution authority still sees that some parts of existing resolution framework are not sufficient to address specific features of Islamic banks and its products. This issue motivates the discussion between Indonesia Deposit Insurance Corporation (IDIC) as the sole bank resolution authority in the country to conduct a series of discussions with Dewan Syariah Nasional (DSN) or National Sharia Council as the authority responsible for issuing fatwa in Islamic-finance-related matters. Both authorities later agree to develop fatwas, regulations and guidance on resolution of Islamic banks in Indonesia.

This paper investigates Sharia concerns on existing bank resolution framework and propose recommendations on how to resolve those concerns in Sharia-compliant manners. It also assesses compatibility of resolution powers mandated by the FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions if it is applied to resolve failed Islamic banks, especially focusing on operational aspect of executing the resolution options. In general, the questions to be answered in this paper are: 1) Can resolution process of conventional banks applied to Islamic banks?; 2) Is

there any sharia issue involved if the resolution of Islamic banks is being conducted in conventional manners?; 3) If yes, how shall the sharia issues be resolved?

The paper is organized as follows: literature review section discusses existing literatures on the topic of bank failures and resolution, both from conventional and sharia-related perspectives. Next, the research method section discusses the main research questions this paper aims to address, and the approach it takes to answer those questions. In the results and discussion section, suitability of sharia compliance is discussed for each of the aspects in the Key Attributes. Lastly, the conclusion section concludes the paper and provide recommendations for policymakers' consideration.

## Literature Review

### Bank Failure and Bank Resolution

Insolvency and bankruptcy are common issues faced by all types of industries. Nevertheless, bankruptcy or failure of banks tend to cause more adverse impact on financial stability. According to White and Yorulmazer (2014), the costs specific to bank failures can be categorized into four categories. First, bank failures may lead to disruptions to the customers of the bank, both depositors and borrowers alike, thus resulting in significant welfare losses (Kahn & Santos, 2005; Gorton & Huang, 2004, 2006). Second, a bank's failure is likely to trigger contagion to other financial institutions in the form of direct losses through its borrowing and lending relationships (Allen & Gale, 2000), or through information contagion via negative sentiments that runs in the mind of the people (Chen, 1999; Acharya & Yorulmazer, 2008). Third, bank failures might incur fiscal costs from the government's side, e.g. through disbursement of claims payment from the deposit insurer to failed bank's depositors<sup>1</sup>. Fourth, bank failures might induce "moral hazard" issues, as bank managers would think that an implicit "safety net" exists as governments would step in whenever a bank is in trouble (Grossman, 1992; Anginer & Demirgüç-Kunt, 2018). This tends to encourage bank to take excessive risk, increasing the systemic risk as a whole.

When a bank experiences failure, in order to avoid or minimize costs of such failure, regulators, particularly bank resolution authority used various resolution options. DeYoung et al. (2013) listed the main options for bank resolution used by FDIC. Table 1 ranks the options based on its liquidity preservation characteristics.

**Table 1.** Types of Resolution Options

Resolution technique	Description
Open Bank Assistance	Capital injection or liquidity assistance provided to banks, while bank owners remain intact, or with resolution authority in control.
Forbearance	Allowing insolvent or undercapitalized bank to continue to operate (often with old management intact).
Bridge Bank/Bridge Institution	A temporary bank is created with the resolution authority in control. Asset and most liabilities of the failed bank is transferred into this temporary bank. Old ownership, creditors, and management are severed from the bank.
Purchase and Assumption	Acquirer of failed bank purchases designated assets from the failed bank and assumes the liabilities.
Partial Payout	Acquirers of failed bank are allowed to only bid on a subset of the failed banks deposits. The rest of the deposits are paid directly by the deposit insurance authority.
Asset Liquidation	Failed bank assets are liquidated by the resolution authority. The proceeds of sale are used to pay back the depositors of the banks.

Source: DeYoung, et al. (2013), adjusted by Author

<sup>1</sup> In the case of Indonesia, the claims payment to depositors of failed banks is mandated by the IDIC Law (Undang-undang No. 24 Tahun 2004 tentang Lembaga Penjamin Simpanan)

At the international level, White and Yorulmazer (2014) summarized that government interventions and resolutions of financial institutions during 2008 crisis episode in the US and Europe tend to be similar to each other. The resolution options used at that time range from capital injection either from the government or from private consortium, purchase & acquisition by the government or by other larger private institutions, and liquidation or bankruptcy. Resolution options available in various countries may vary depending on the regulations. Indonesia, for example, only have four resolution options: open bank assistant (OBA), bridge institution (BI), purchase and assumption (P&A), and liquidation. In Malaysia, Islamic Financial Services Act (Laws of Malaysia Act 759, 2013) sets out resolution options for Islamic bank failures, that similarly allows OBA, BI, P&A, and liquidation.

To ensure effective resolution process when needed, the Financial Stability Board (FSB) published the Key Attributes. Basically, the Key Attributes serves as an element of policy measures post-2008 Financial Crisis to address the problem of financial institutions being “too big to fail.” The measures aim to reduce both probability and impact of failure of Systemically Important Financial Institutions (SIFIs). To reduce the probability of failure, the Key Attributes state the requirements for additional loss absorption capacity for financial institutions categorized as global SIFIs (G-SIFIs), along with increased supervision of FIs. To reduce the impact of failure, the Key Attributes describe the essential features of a resolution regimes that should be implemented by the resolution authorities in case of SIFI failures. The Key Attributes outlines 12 key attributes that discuss legal frameworks and arrangements, resolution powers and tools, legal safeguards, funding, recovery and resolution planning, and cross-border cooperation (Financial Stability Board, 2014).

Aside from FSB, a number of regional bodies have also established frameworks, guidance, and technical notes with regards to bank resolution. For example, The Basel Committee on Banking Supervision outlines the requirements for a clear mandate and a legally backed resolution powers for each authority which serves as the basis for an effective institutional framework for crisis management and resolution (Basel Committee on Banking Supervision, 2012). The legal framework also includes a range of powers and tools that the regulatory authorities can utilize in their respective jurisdictions should any institutions are deemed likely to fail.

At country and regional levels, the EU has also published a framework that suggests comprehensive arrangements for dealing with failed banks at the national level as well as to resolve cross-border banking failures. In the US, the Dodd-Frank Wall Street Reform and Consumer Protection Act/“the Dodd-Frank Act” (2010) has established a recovery and resolution framework for systemically important financial institutions. The aim of the Dodd-Frank Act is to uphold financial stability of the financial system by improving accountability and transparency in the system, to reduce “too big to fail” exposures, to protect the taxpayers, and to protect consumers at large (Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010).

## **Previous Studies**

In the academic field, numerous studies have been conducted on the topic of failed conventional banks, including Brock (1998), Hüpkes (2004), Beck (2004), Beck and Laeven (2006), Sharma (2011), among others. However, only few studies focus their attention on failed Islamic banks. One of such studies is Ali (2007) that mentions some of notable failures of Islamic banks, including Ihlas Finance House (IFH) collapse in Turkey in 2001, in which, many considers as the most serious case in Islamic bank failure as well as Bank Al Taqwa closure in 2001. Aside from Ali (2007), Nathie (2010) studies the failure of The Islamic Bank Ltd (IBL) of South Africa in 1997. The mentioned studies tend to focus more on the factors leading to the collapse, rather than discussing the resolution exercise of the authority. However, Nathie (2010) did conclude that should the regulator intervened early into IBL, it would have helped its liquidity problem and would have forestalled its collapse.

One study that raises concern on the lack of guidance on resolution framework of Islamic banking industry is Awadzi et al. (2015), in a paper issued by the International Monetary Fund (IMF). This study discusses the design of legal frameworks needed for the resolution of Islamic banks, as well as the compatibility of FSB’s Key Attributes in the resolution of Islamic Banks.

Among other comprehensive discussions, the paper also highlights a number of institutional issues encountered in exercising resolution of Islamic Banks. First, the international standards (FSB's Key Attributes) for the design of the resolution authority may be broadly appropriate for both conventional and Islamic banking systems. Second, in countries with dual banking systems, the question arises as to which agency is best suited to act as resolution authority for Islamic banks. As such, it is imperative to ensure that the authority possess sharia expertise and capability on hand. Third, in designing a sharia-compliant regime for resolution, it is important to ensure that institutional arrangements promote orderly resolution.

Awadzi et al. (2015) also recommends that the design of a resolution regime for Islamic banks needs to consider and allow for the distinct features of their balance sheets. In determining the method for recovery and resolution for Islamic banks, attention must be given on how the contracts and operations of Islamic Banks differ from conventional banks. Moreover, in several jurisdictions where the contributions of both conventional and Islamic finance are relatively significant, it would be appropriate to consider whether it is feasible to establish separate legislation and regulations to deal specifically with Islamic Banks.

Following Awadzi et al. (2015), Ali and Al Mamun (2017) write comprehensive analysis on recovery, resolution, and insolvency issues for institutions offering Islamic financial services. This study was undertaken as the initiative of Islamic Financial Services Board (IFSB), in which, as international standard setting body for Islamic financial services industry, it also has concerns on the resolution issue of Islamic banks. This paper highlights the current state of recovery and resolution framework for Islamic banking industry and provide some possible thoughts on some issues related to the resolution of Islamic banks as highlighted in Awadzi et al. (2015).

Nevertheless, detailed explanation on the possible sharia issues that resolution authorities could encounter when exercising resolution options for Islamic banks and how to deal with those issues is still relatively unexplored. It is understandable, as many countries with Islamic banking industry, including OIC and IFSB member countries, are still behind other countries in developing the third pillar of financial safety nets, which are deposit insurance and resolution framework. While the IFSB and International Association of Deposit Insurers (IADI) have issued the Core Principles for Effective Islamic Deposit Insurance System (CPIDIS) in 2021, guidances on how the resolution for Islamic banks should be designed and conducted are not yet available.

## Research Methods

This paper adopts qualitative approaches to achieve its objectives. It uses extensive literature studies in exploring sharia issues in existing bank resolution frameworks, particularly through assessment on resolution powers that should be possessed by the resolution authority according to the Key Attributes. Following this, a number of focus group discussions (FGD) are undertaken.

The first FGD was held on 15<sup>th</sup> July 2020 which was attended by internal staffs of IDIC and representative from DSN. In the FGD, authors identified issues in resolution of Islamic bank and confirmed those issues with relevant staffs who execute bank resolution activities following bank failures. The second FGD was organized on 14<sup>th</sup> December 2020 and was attended by representatives from Asosiasi Bank Syariah Indonesia (ASBISINDO), as well as representatives from the biggest Islamic banks in the industry, such as Bank Syariah Mandiri and Bank Muamalat Indonesia, and the biggest Islamic windows, such as Permata Syariah. In this FGD, authors aimed to understand the method of selling and transferring non-performing assets, as one of the most crucial issues during bank resolution. The third FGD was held on 15<sup>th</sup> January 2021 and was attended by representatives from Komite Penyusun Standard Penilaian Indonesia (KPSPI) or Committee for Asset Valuation Standardization, Ikatan Akuntan Indonesia (IAI) or Indonesia Accountant Association, as well as DSN. This FGD emphasized the discussions on how asset valuation is supposed to be conducted from Islamic point of view. Afterwards, the fourth FGD was organized on 18<sup>th</sup> March 2021. This FGD was attended by representatives from other regulators, such as Bank Indonesia (BI) as Central Bank, and Otoritas Jasa Keuangan (OJK) as the Financial Services Authority. In this FGD, authors presented compilation of recommended regulatory framework for resolution of Islamic bank, in which we aimed to harmonize it

framework with other relevant regulators at other regulatory authorities. The FGDs were performed in group interviews format, in which the authors participated in the discussion as moderators.

## Results and Discussion

The section provides information on results of the FGDs series. As explained earlier, the first step in investigating whether or not existing resolution framework is applicable to Islamic banks is by exploring possible sharia issues on resolution powers that the resolution authority should have according to the Key Attributes. Table 2 shows that the participants of all FGDs agreed that the existing bank resolution framework can be applied to Islamic banks as a number of resolution powers contain no sharia issues. However, some other resolution powers may have certain sharia issues, but can be tolerated subject to certain conditions. As for the rest of the powers, the powers require specific adjustments to make it comply with sharia rules and principles.

Resolution powers that have no sharia issue include the power to ensure continuity of Islamic bank's essential services and functions by requiring other banks in the same group to continue to provide essential services. Aside from that, the power to establish a temporary bridge institution to take over and continue operating certain critical functions and viable operations of a failed Islamic bank also has no associated sharia issue. However, the bridge institution has to be registered as an Islamic bank and operate in accordance with sharia rules and principles.

Some resolution powers initially have sharia issues, as concerned by representative from DSN. This is because the power is executed through one-way decision making process without considering the interest of other parties. The powers in question include the power to remove and replace the senior management and directors and to recover funds from responsible persons; the power to appoint an administrator to take control of and manage the affected firm; the power to override rights of shareholders of the firm in resolution; the power to temporarily delay the exercise of early termination rights; the power to impose a moratorium with a suspension of payments to unsecured creditors and customers; as well as the power to liquidate the whole or part of a failing Islamic bank. Although DSN allows the resolution authority to execute these powers as they represent the will of the country's ruler (*ulil amri*) and has the ultimate responsibility to protect public interest (*maslahah*), the DSN demands a set of clear criteria as the basis prior to executing such powers. In addition, the powers are given and allowed only during times of necessity and emergency in a bank failure episode, or during financial crisis to prevent worse thing from happening.

The rest of the resolution powers have sharia issues especially in the way those powers will be executed. For example, the power to operate and resolve the Islamic bank, including terminating contracts and writing down debts; the power to transfer or sell assets and liabilities particularly Islamic financing instruments; the power to establish a separate asset management vehicle and transfer to the vehicle for management and run-down non-performing financing or difficult-to-value assets; and the power to carry out bail-in within resolution process. These issues are emphasized by IDIC staffs based on their experiences in liquidating Islamic rural banks.

**Table 2.** Sharia Compliance Assessment on Resolution Powers of Resolution Authority

No	General resolution powers of bank resolution authority	Sharia issues
1	Remove and replace the senior management and directors and recover funds from responsible persons, including claw-back of variable remuneration;	May have sharia issue; can be applied, as long as there is evidence/strong argument behind it (e.g. fraud, etc).
2	Appoint an administrator to take control of and manage the affected firm with the objective of restoring the firm, or parts of its business, to achieve ongoing and sustainable viability;	May have sharia issues; can be applied in Islamic bank by the resolution authority as representation of country's ruler.

No	General resolution powers of bank resolution authority	Sharia issues
3	Operate and resolve the firm, including powers to terminate contracts, continue or assign contracts, purchase or sell assets, write-down debt and take any other action necessary to restructure or wind down the firm's operations;	Have sharia issues, particularly in relation to the termination of contracts, asset sale particularly the debt-like financing products, and write-down of debts.
4	Ensure continuity of essential services and functions by requiring other banks in the same group to continue to provide essential services to the entity in resolution, any successor or an acquiring entity; ensuring that the residual entity in resolution can temporarily provide such services to a successor or an acquiring entity; or procuring necessary services from unaffiliated third parties;	No sharia issue
5	Override the rights of shareholders of the firm in resolution, including requirements for approval by shareholders of particular transactions, in order to issue a permit for merger, acquisition, or sale of substantial business operations, recapitalization or other measures to restructure and dispose of the firm's business or its liabilities and assets;	May have sharia issue; can be applied based on public interest (maslahah) perspective or in case of emergency.
6	Transfer or sell assets and liabilities, legal rights and obligations, including deposit liabilities and ownership in shares, to a solvent third party, notwithstanding any requirements for consent or novation that would otherwise apply (see Key Attributes);	Have sharia issues, particularly on transferring liabilities.
7	Establish a temporary bridge institution to take over and continue operating certain critical functions and viable operations of a failed firm;	No sharia Issue, as long as the bridge institution can operate in accordance with Sharia rules.
8	Establish a separate asset management vehicle (for example, as a subsidiary of the distressed firm, an entity with a separate charter, or as a trust or asset management company) and transfer to the vehicle for management and run-down non-performing loans or difficult-to-value assets;	Have sharia issue, can be applied with appropriate sharia contracts and transfer mechanism.
9	Carry out bail-in within resolution as a means to achieve or help achieve continuity of essential functions either (i) by recapitalizing the entity hitherto providing these functions that are no longer viable, or, alternatively, (ii) by capitalizing a newly established entity or bridge institution to which these functions have been transferred following closure of the non-viable firm (the residual business of which would then be wound up and the firm liquidated);	Have sharia issues, need to find justification from sharia perspective particularly for statutory bail-in, determine appropriate mechanism and sharia instruments that are "bail-in-able".
10	Temporarily delay the exercise of early termination rights that may otherwise be triggered upon entry of a firm into resolution or in connection with the use of resolution powers;	May have sharia issues; can be applied in Islamic bank by the resolution authority as representation of country's ruler.
11	Impose a moratorium with a suspension of payments to unsecured creditors and customers (except for payments and property transfers to central counterparties (CCPs) and those entered into the payment, clearing and settlements systems) and a stay on creditor actions to attach assets or otherwise collect money or property from the firm, while protecting the	May have sharia issues; can be applied in Islamic bank by resolution authority as representation of country ruler.

No	General resolution powers of bank resolution authority	Sharia issues
	enforcement of eligible netting and collateral agreements;	
12	Trigger the closure and orderly wind-down (liquidation) of the whole or part of a failing firm with timely payout or transfer of insured deposits and prompt (for example, within seven days) access to transaction accounts and to segregated client funds).	May have sharia issues: specifically on type of sharia instruments that are insured and transferable.

Source: The Key Attributes, analyzed by the author

Other than sharia issues within these resolution powers, there are also some sharia issues that can be found in other aspects as set by the Key Attributes, such as in set-off, netting, collateralization, and segregation of asset. Moreover, further discussion is needed to explore Sharia issues in funding the resolution process, cross-border resolution, as well as recovery and resolution plan for Islamic banks. This study, however, focuses on sharia issues in operational aspect of executing resolution options. Table 3 provides potential sharia issues in various activities that are required in executing resolution options.

The following sub-sections discuss in more details about the sharia issues associated with executing resolution options, as well as the recommendations on how to resolve the issues. Most of the recommendations have been adopted as fatwa and regulation, while the rest are still subject to further discussions between the DSN and IDIC as the Resolution Authority.

**Table 3.** Sharia Issues in Operation of Resolution Options

No	Issues	Resolution options	Sharia issues
1	Recapitalization/Capital Injection	OBA, BI	Non-cash capital injection.
2	Transferring deposit	OBA, BI, P&A	Types of transferable deposits, treatment on profit sharing and sharia compliance mechanism of transferring liabilities.
3	Transferring assets	OBA, BI, P&A, Liquidation	Sharia-compliant mechanism in transferring assets, particularly Islamic financing instruments.
4	Transforming debt into equity and write-down of debt	OBA, BI, Bail in	Sharia basis for transforming debt into equities, types of debt that can be transformed into equities; and conditions for write-down.
5	Liquidity Assistance	OB, BI	Types of financing and liquidity instruments.
6	Asset Management	OBA, BI, Liquidation	Sharia-compliant mechanism in transferring assets under management to other asset management company.
7	Treatment in Asset Valuation	P&A, Liquidation	Treatment on unrealized margin, ownership portion in ujr that has been paid, ownership portion in joint equities.
8	Creditor's Hierarchy	BI, P&A, Liquidation	Depositors' preference, treatment of Islamic social funds such as zakat and waqf as well as undisbursed charitable funds from sharia non-compliant income.
9	Set-off, Netting, Collateralization	P&A, BI, Liquidation	Condition for applicability of set-off.
10	Merger & Consolidation, Segregation of Assets, and Divestment	OBA, BI	Merger and consolidation of Islamic banks; Islamic bank sale, separation of existing business of Islamic bank and combination with business entities of other banks.

Source: Author's compilation of Fatwa, Regulations, and discussions with DSN



### Recapitalization/Capital Injection

Recapitalization or capital injection is a crucial activity in OBA and BI. Initially, there is no sharia issues associated with this activity, particularly if the capital injection is done in cash. The sharia issue, however, appears if the resolution authority provides non-cash capital injection<sup>2</sup>. While equity participation in form of real asset or sukuk is considered acceptable by existing fatwa, there is also a fatwa on mudharabah that prohibits capital injection in form of debt (Dewan Syariah Nasional, 2017b).

As highlighted in the first series of FGD, during financial crisis, the resolution authority perhaps does not have enough funds to support OBA or BI options, particularly in form of cash. They might not also have adequate sharia-compliant investment instruments (such as Islamic bonds or sukuk) to be placed in Islamic bank as equity. Therefore, participant of the first FDG from IDIC's treasury department there is a discussion on an alternative to this issue, in which, the resolution authority may issue its own sukuk and use this as equity participation in failed Islamic bank, as part of OBA, or to support establishment of BI. The problem arises as there is a possibility that the resolution authority does not have enough asset to be used as underlying asset for the issuance of such sukuk. Thus, further discussion is required as to whether or not the resolution authority could issue mudharabah sukuk based on resolution authority's activity as the underlying asset, where the income generated from premiums collected from Islamic banks in the future is used to pay the sukuk holders.

### Transferring Deposit to Other Islamic Banks

The issue of transferring deposit is not only an issue in resolution of Islamic banks. This issue has been widely discussed in the area of Islamic deposit insurance, including by Sharia Board of Islamic Financial Services Board (IFSB)/Islamic Development Board (IsDB) when IFSB and IADI developed CPIDIS (International Association of Deposit Insurance and Islamic Financial Services Board, 2021). The cross-over issue between Islamic deposit insurance and resolution of Islamic banks lies on the type of deposit instruments that are covered by Islamic deposit insurance. If the instruments are covered by the insurance, thus, it can be transferred to other Islamic financial institution during P&A and BI, or through other sharia-compliant transfer mechanisms.

According to CPIDIS (International Association of Deposit Insurance and Islamic Financial Services Board, 2021), there would be no sharia issue in insuring wadiah-type deposit by Deposit Insurers. Nevertheless, there is further consideration on deposit or investment account that is based on mudharabah contracts. In the case of Indonesia, as pure investment account rarely exists, DSN allows deposit based on wadiah and mudharabah to be insured by IDIC (Dewan Syariah Nasional, 2018). However, it is prohibited for IDIC to guarantee bonus of the wadiah and profit sharing for mudharabah. Therefore, in the case of P&A and BI for Islamic bank, IDIC as resolution authority can transfer wadiah and mudharabah deposit to other Islamic banks or newly established Islamic bank as BI, but excluding the bonus and profit sharing portion of such instruments.

Fatwa and regulations on non-transferability of profit-sharing portion can also be used as the basis argument on the treatment of Profit Equalization Reserve (PER) and Investment Risk Reserve (IRR). Awadzi et al. (2015) mentioned that the treatment of PER and IRR as one of issues that need further guidance in the topic of Islamic bank resolution. However, as PER is typically constructed based on the profits that belong to both Islamic bank and investment account holders (IAH), those profits basically has been donated by both parties to the reserve account. So, neither the Islamic bank nor IAH could claim the funds belong to that reserve during bank resolution. On the other hand, IRR is constructed based on profit solely owned by IAH. Therefore, the IFSB in its Guidance on Corporate Governance (IFSB-3) suggests that at the point of insolvency, the PER and IRR can be distributed to the existing Investment Account Holders (IAH) and shareholders. Another alternative is to donate the reserve to charities (Ali & Al Mamun, 2017). Nevertheless, in

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<sup>2</sup> Non-cash capital injection is the capital injection without actual cash being transferred into the bank, e.g. through provision of sukuk, or via debt conversion.

the real scenario of Islamic bank failure, the amount of PER and IRR are supposed to be depleted. Learning from cases of Islamic bank failure in Indonesia, the banks tend to smooth profit payout to depositors, even when they do not generate profit at all.

With regards to sharia-compliant mechanism on transferring Islamic bank's liabilities including the Islamic deposit, representative from Dewan Syariah Nasional recommends the use of hawalah contract to be the basis of this transaction. Hawalah, however, is a contract based on the transfer of debt which can only be executed at par. Therefore, any discount or premium applied to this transaction will be considered as riba, thus, is not allowed from Islamic finance perspective. Nevertheless, it would be difficult to find other financial institutions who are willing to accept debt of other parties without receiving any incentives. As a solution for this problem, the DSN allow hawalah to be executed through an exchange of liability and asset (Dewan Syariah Nasional, 2019). In this case, during P&A and BI, the resolution authority will transfer liabilities of the failed Islamic bank, particularly the insured deposit to assuming bank or BI, and compensate the assuming bank or BI with good assets from the respective failed Islamic bank. As the value of the good assets may change over the time, there is market risk attached to that asset. To cash in such asset, the assuming bank or BI also need to eventually sell the asset. This means, there is additional effort and risk that should be borne by the assuming bank or BI, in which, may be considered as iwadh or countervalue to the profit that they receive from such transaction. As highlighted by Rosly (2008), profit is not considered as riba as long as there is iwadh (compensation) for the transaction. This mechanism, therefore, solve the riba issue in transfer of Islamic bank liabilities in the case of P&A and BI.

### **Transfer of Islamic Bank Assets**

There is no sharia issue in the transfer or sale of Islamic bank assets if the assets belong to fixed assets category, such as building, cars, equipment, etc. Sharia issues may arise in the transfer or sale of Islamic financing instruments. In the case of Indonesia, the DSN also allows Islamic banks to sell Islamic financing instruments which are based on partnership contracts, such as mudharabah and musyarakah, as well as Islamic financing instruments that possess underlying assets, such as ijarah and musyarakah mutanaqisah, to be sold directly to the third party in exchange of cash (Dewan Syariah Nasional, 2019). Nevertheless, transfer or sale of receivable-based Islamic financing instrument cannot be done, as they are considered as straight non-debt based Islamic financing. This is because receivable possesses similar characteristics as debt, and is only allowed to be transferred or sold at par. Any discount or premium will be considered as riba, thus, is not allowed from sharia-compliance perspective.

As a solution for this problem, the DSN allows the resolution authority to sell receivable-based Islamic financing with assets or goods as medium of payment (Dewan Syariah Nasional, 2019). This sale mechanism is similar to the case of hawalah in the transfer of bank's liabilities. As there is inherent market risk in that transaction, and the assuming bank or BI should commit effort to sell those assets, profits from such transaction is not considered as riba because it fulfills the requirement of iwadh (Rosly, 2008). However, in the first FGD series, representatives from IDIC highlight the difficulties in executing this mechanism. Moreover, representatives from Islamic banks in the second FGD series highlighted that it is not a common practice yet in the market.

### **Transforming Debt into Equity and Write Down**

Transforming debt into equity is the basis of bail-in and is a crucial issue that needs further guidance in the topic of Islamic bank resolution. The transformation of debt into equity, however, can also be found in other aspects of bank resolution and bank restructuring programs. The resolution authority can also transform the debt owed by the bank to the authority into equity, and the debt of third party to the bank as equity of the resolution authority on the third-party firms. Nevertheless, as highlighted earlier, there is fatwa on mudharabah that disallowed debt to be transformed into equity. Thus, this practice is not applicable to Islamic banks under normal circumstance (Dewan Syariah Nasional, 2017b).

Nevertheless, the DSN has issued fatwa on convertible sukuk (Dewan Syariah Nasional, 2020) that can be used as the basis for contractual bail-in. According to this fatwa, certain type of mudharabah sukuk can be converted into equity as long as the sukuk holders as investors has provided their agreement which is reflected in the sukuk contracts. However, there is still a question of whether statutory bail-in (bail-in enforced by the resolution authority on the failed bank's creditors) is allowed from Islamic point of view. If so, what type of instruments that are bail-in-able? This issue is one of the crucial points in resolution of Islamic bank that is still need to be resolved. This issue is also gotten attention from other Otoritas Jasa Keuangan and Bank Indonesia as bail in is an important element in preventing banking crisis.

There are more issues in relation with bail-in that need further discussion and regulations. For example, how to treat investment accounts during resolution; Whether the particular instrument can be included among the objects of bail-in; How the treatment of sukuk that have specific assets or businesses as underlying asset (e.g. ijarah sukuk) should be, whether it is bail-in-able or not. Learning from practices in conventional banks, some collateralized debt or liabilities that have specific links to real assets are not bail-in-able. Therefore, there is recommendation during the discussion that restricted investment account and ijarah sukuk, perhaps, are not subject to bail-in. Nonetheless, representative from DSN stressed that liabilities that are backed by asset are actually more acceptable to be transformed into equity, as assets and goods can be used as equity participation.

With regards to debt write-down, sharia initially prohibits this practice (Ali & Al Mamun, 2017), as similar case is also found in Indonesia. However, representative from DSN explain that it is allowed that resolution authority to execute the write-down if there is strong argument behind it. For example, if there is a strong indication and evidence that the creditors behind such liabilities are involved in fraud that leads to the bank failure, then such write-down is considered permissible. Nevertheless, the representative from DSN also stressed that the creditors would still be given the chance to claim their funds if later on the legal court or internal mechanism at the resolution authority proves that the creditors are entitled to get their funds back.

### **Liquidity Assistance**

Liquidity assistance is normally given in form of a loan. However, a straightforward loan with interest is not allowed in Islamic finance (as is considered *riba*). Therefore, in providing liquidity assistance to failed Islamic banks that receive OBA or to BI, the resolution authority should structure the loan as sharia-compliant financing instrument.

In the case of Indonesia, the DSN has issued fatwa on Sharia-Compliant Lender of the Last Resort (Dewan Syariah Nasional, 2017a). This fatwa was actually given to Bank Indonesia as the Central Bank that owned such responsibility. Representative from DSN suggested that the fatwa, can also be used by the resolution authority as the nature of financing given to failed Islamic bank have similar characteristics. However, representative from IDIC argued that the liquidity assistance, however, is only allowed to be used for certain purpose, considering the limited mandate owned by the IDIC as given by IDIC Act.

### **Asset Management**

There are two major activities under asset management as part of bank resolution: restructuring and sale of the bank's asset (including financing instruments) to the third parties. Based on the third FGDs series with representatives from Islamic bank, it can be concluded that there is no difference in the way resolution authority restructures Islamic financing instruments with how Islamic banks restructure their non-performing financings. In terms of sale of Islamic financing instrument, the asset management activity shall follow the fatwa that fixed assets and non-debt-based financing instruments can be sold in exchange for cash, while the sale of receivable-based financing should be conducted with assets or goods as the method of payment (Dewan Syariah Nasional, 2019).

One thing that need to be observed, however, is how the assets of failed Islamic banks is transferred to asset management companies by the resolution authority. In the case of Indonesia,

the resolution authority is able to handle asset management program by themselves, thus, this issue is not relevant. However, the resolution authority could also appoint asset management company to take over the asset management activities on behalf of them, or sell failed Islamic bank assets to respective asset management companies directly to prevent the prices of such assets deteriorate quickly. Based on this condition, IDIC staff request for opinion from DSN on what kind of Islamic contract or *Aqad* that can be used for such transaction.

Based on the the results of the discussion, for the first option, Wakalah contract can be used as the basis of agency relationship between the resolution authority and the asset management company. Asset management company will receive ujr or fees for their services. On the other hand, the resolution authority can sell the assets of failed Islamic banks to the asset management company and let the asset management company sell the assets to other parties, using Al bai or trading principle. In these circumstances, the way the resolution authority sells the bad asset of Islamic bank to asset management company, and how the asset management company sells the respective assets to other parties should comply with the fatwa explained earlier.

### **Treatment in Asset Valuation**

There are two sharia-related questions with regards to valuation of asset of failed Islamic bank. First, whether the existing valuation methodology are already in line with sharia rules and principles. Second, whether there is any impact of aqad or Islamic financial contracts to the value of Islamic financings.

Answering the first question is very challenging. We understand the existing valuation methodology is based on the concept of Time Value of Money (TVM), in which, the concept has been criticized by many Islamic scholars. One reason behind it is that the method uses interest concept to value the asset. In addition, the use of future income may also contain gharar or speculation elements, in which, gharar, in addition to riba, is also prohibited in Islamic finance. Nevertheless, to the best of our knowledge, there is no substitute for existing valuation method yet that we can reliably use for Islamic finance and claim to be sharia compliant. This is confirmed in the third FGD as well, in which the valuation expert sees no substitution for asset valuation specific for Islamic banks. This opion is also supported by representative of DSN and representative from Indonesia Accountant Association as both organizations have worked together to come out with such measurement. But to this extend, no recommendation has been provided yet. Therefore, it can be concluded that the conventional valuation method is still used in resolution of Islamic bank.

The second question is relatively easy to answer. However, as found by the third FGD, in the field, many Islamic bankers are not aware of this issue. Islamic financial contracts have strong influence on the value of Islamic financing, particularly due to “who owned the assets” and portion of bank and customer ownership on those assets.

There are a lot of problem with regard to this issue that can be found in the market. In murabahah financing for example, underlying assets of the financing has been sold to customer, but the customer is indebted to the Islamic bank, as much as the cost of asset plus some profit margin, as charged by the Islamic bank according to contractual agreement. Based on sharia principle, when the customer wants to have early settlement, they still need to pay the purchase price, in which, cost plus profit margin as set in the contract, minus any installments that have been paid by the costumer. Islamic bank, however, can provide Ibra' or discount to neutralize the unearned profit. Nevertheless, there are many disputes in the practice, as Islamic bank tend not to be willing to give the discount. In this case, the outstanding amount that have to be paid by the customer was rather illogical, so that when customer brought this case to the Court, the Court decides that the Islamic bank needs to reduce the selling price (Rosly, 2008).

The same case could potentially happen in the event of insolvency of Islamic bank. As the resolution authority usually hires third party to liquidate Islamic bank assets or appoint asset management company to deal with bad assets, the third party or asset management company could potentially ignore the right of customers to get the ibra'. This is because in contractual term, giving ibra' is the right of failed Islamic bank, and the right, now is transferred into the hand of the resolution authority, and the resolution authority has mandated the asset management company to

deal with the customers. As their key performance indicator is to generate returns and profits as much as possible and understanding on Islamic finance is relatively low in the market, clear rules and guidances need to be provided to protect the interest of Islamic banks' customers during bank failure. Failing to do so could lead to customers become dissatisfied and bring the case to Court. During the FGD, representative from IDIC highlighted the possibility of this circumstance occur during resolution of failed Islamic bank. It will make the resolution process become ineffective and create unnecessary noise in public, which can reduce market confidence that is very crucial in maintaining financial stability, especially during financial crisis.

### **Creditors' Hierarchy**

Basically, sharia rules require all creditors to be treated equally. So, the priority of claim, ideally, should not be applied in Islamic deposit Insurance (International Association of Deposit Insurance and Islamic Financial Services Board, 2021). However, as highlighted by IDIC representative in the first FGD series, eliminating creditors' hierarchy in overall resolution process is difficult to be implemented. By law, depositors are prioritized by the government over other banks' liability to preserve banking stability. This is the reason for having deposit insurance scheme and giving deposit owners better treatment as compared to other types of liabilities during bank resolution.

The rest of the liabilities, thus, have to be treated equally. Nonetheless, again, there are some liabilities that are given priority in the practice, such as bank's liability to Central Bank and to Government. Specific to the case of Islamic bank, representative from Bank Indonesia and Otoritas Jasa Keuangan aspired for Islamic deposit insurance system to provide full guarantee on Islamic social funds such as zakat, infaq, shadaqah and waqf that are placed in Islamic bank, once the respective bank experience failure. The similar expectation is also applied to non-halal income that has to be distributed to charity, but before such funds is distributed, the bank license has been revoked by regulatory authority.

Nevertheless, according to representative from IDIC, the Islamic social funds and the charitable fund are categorized as third-party funds under normal resolution regime. So, the funds will be paid according to the rules, in which, will be distributed according to the rules. For example, deposit insurance fund will be used to reimburse insured deposit and pay necessary liabilities such as the salary of Islamic bank's employees, liabilities to Central Bank, etc. Revenues generated from the liquidation of Islamic bank assets will be used to recover the deposit insurance fund. If there is any excess from those revenues, it will be used to compensate uninsured deposit and other liabilities, including those Islamic social funds and charitable funds. But at this point, portion of fund that is left is almost none or very minimum. At this point, adjustment to creditors' hierarchy is needed, as argued by representative from DSN. Considering that the Islamic social funds belong to those who needed, it is prohibited for those who do not have right to consume it.

### **Set-off and Netting**

Set-off and netting, together with segregation of assets are among the Key Attributes recommendations given by FSB to ensure effective resolution regime. According to representative from National Sharia Council, sharia rule allows set-off based on the concept of muqasah. But it is more preferable to be used in the case of liquidation rather than in other resolution options, particularly P&A or BI.

However, according to representative of IDIC, set-off is not applicable to P&A and BI unless for non-performing financing or to customers or any parties who have been proven or have strong indication of doing fraud that leads to the failure of respective Islamic bank. Because in P&A and BI the bank's business is still continuing, the clients' business is still continuing as well. It would be difficult for the customer to receive the fact that they will not receive money from their deposit back if it is used to compensate their financing. They will need to get refinancing from other bank if they need such cash soon, and the new deal with other bank could possibly be unfavourable to them.

IDIC representative also emphasized on difficulty to apply set-off for conventional banks with Islamic windows, if the assets and liabilities are cross-over, for example one asset/liability

belongs to the Islamic windows while the other belongs to the conventional services. In the case of Indonesia, the asset of Islamic bank is only allowed to be sold to other Islamic bank or to Islamic windows of conventional bank. Therefore, it is much easier to not set-off customers assets and liabilities, unless there is strong argument behind it.

### **Merger and Consolidation, Segregation of Assets, and Divestment**

There is no specific sharia issue in merger and consolidation especially if the resolution authority has ownership to failed Islamic bank as consequence of OBA or BI. Similarly, the resolution authority could also order segregation of bank assets or merger of such assets with assets of other bank if it is considered the best decision for the bank and for the public at large. However, the result of merger and consolidation as well as segregation of assets of Islamic bank should maintain sharia-compliant status of the bank and those assets.

In the case of divestment, according to Indonesian Islamic Banking Act (UU No. 21, 2008), it is prohibited for Islamic bank to change its business to conventional bank. Therefore, once Islamic bank receive OBA from IDIC, or when IDIC establish BI, when the Islamic bank is sold to the third party, the bank should remain an Islamic bank. If the bank is sold to conventional bank, the Islamic bank will be Islamic subsidiary of the conventional parent bank. In the case that conventional bank has Islamic windows, there is option that Islamic bank is merged with the Islamic windows, or the Islamic windows is moved to Islamic bank and become independent subsidiary of the conventional bank.

### **Conclusion**

In general, existing bank resolution framework can be applied to Islamic bank. However, there are some resolution powers given to the resolution authority that have inherent sharia issues but are still allowed to be exercised according to the DSN because the resolution authority represents the will of the country's ruler (*ulil amri*). Nevertheless, there supposed to be clear set of measures to those powers prior to be implemented, and the purpose of executing such power should be only to maintain public interest, particularly to preserve financial stability.

On the other hand, there are implementation of resolution powers that need to be adjusted, particularly in operating resolution options. Some regulations and necessary infrastructures need to be established prior to undertaking actual resolution of Islamic banks, such as the mechanism of sale of transfer of receivable-based Islamic financing instruments with assets or goods as method of payment, guidance in valuation of Islamic financing instruments to protect the right of Islamic bank's customers, and treatment to Islamic funds and charitable funds during bank resolution. Moreover, there are some issues that need further discussion prior to be regulated. Bail-in of an Islamic bank is among the issues that fall under this category. Sharia solution on this issue is urgently needed before any failure of Islamic bank happens. To pursue this objective, IDIC is continuously coordinating and collaborating with stakeholders particularly with DSN and OJK to develop and establish such guidance. Such guidance may include possible sharia solution to the dilemma encountered in banking resolution, such as for example by utilizing the "*dharurah*" (emergency) concept to allow for some transactions under extreme conditions that could endanger the entire banking system.

In overall, there are a number of sharia-related issues highlighted in this paper have been answered and covered by the new fatwa and regulations on the Resolution of Islamic Bank in Indonesia. The respective fatwa and regulations, therefore, can serve as benchmark for other jurisdictions that aims to strengthen their Islamic financial safety nets. Having strong Islamic financial safety net is very important for a country where Islamic banking industry operates. While most of countries with larger size of Islamic banking industry have specific banking regulatory and supervisory framework as well as sharia-compliant lenders of the last resort ready for Islamic banking industry, many of them still do not have the third pillar of Islamic financial safety net, which is the Islamic deposit insurance and framework for resolution for Islamic banks. At the end,

it is our hope that this paper would be able to lay out the basis for such jurisdictions to complete Islamic financial safety nets in their respective countries.

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