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Crisis Management in the Islamic Financial Services Industry

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The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which includes the issuance of exposure drafts and the holding of workshops and, where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

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CRISIS MANAGEMENT IN THE ISLAMIC FINANCIAL SERVICES INDUSTRY

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Your Excellencies, ladies and gentlemen, this session is largely an exercise in anticipation. We have yet to see a substantial crisis in the Islamic financial services industry, and although we have had a few problem institutions, we have generally been able to resolve the issues at a national level and on a fairly gentle timescale. So, in thinking about how a real crisis might be handled, we need to draw on our experience in conventional finance. In my case, this was predominantly in the Netherlands and later the United Arab Emirates (UAE) during the global financial crisis, but some of you will have other relevant experience – for example, from the Asian financial crisis.

Crises have different characteristics, depending on the sector involved and the degree of interconnectedness. An insurance crisis typically plays out in relatively slow time. The crisis of the early 1990s, triggered by asbestosis and involving the near-failure of Lloyd's, brought down many insurers, but did so over a five- to ten-year period. An individual company may fail overnight, but even then the issues that need to be resolved quickly are generally limited to ensuring continuity of cover in critical areas such as aviation. A banking crisis generally plays out faster, because of the critical importance of liquidity, the speed with which assets can be withdrawn, and the consequent importance of confidence. The Lehman's insolvency can be characterised as a securities crisis, in that the seizing up of elements of the market, and the long uncertainty about the outstanding balances between parties, became more important than the actual debts owed by the firm. This was a case where interconnectedness was critical. On the other hand, the practical experience has been that contagion effects in the insurance business have been very limited.

Of course, we cannot expect that the next crisis will be like the last one, and we should not assume that the characteristics I have identified are absolute for all time. After all, before the global financial crisis, most Western regulators thought that bank runs were essentially things of the past, or at least were confined to less developed economies. They were wrong.

Another important variable in dealing with a crisis is the institutions involved. At the national level, you may have a highly integrated regulatory system, as in Bahrain, or a highly fragmented one, as in the United States, or almost anything between. While there

is plenty of room for debate about the merits of different regulatory structures in general, in a crisis the lines between agencies are almost always problematic. Structural preparation – for example, a coordinating committee – can help. However, trust is critical, and is always in short supply when issues of responsibility or blame are likely to arise. In general, my preference would be for one agency to be given clear lead powers in such a situation, to avoid prolonged paralysis.

These issues become hugely more difficult in a cross-border situation. Legal systems will be difficult, the macroeconomic situation may be different, and regulators will be answerable to different politicians and governmental structures. My own experience of this includes the rescue of Fortis, where even the Dutch and Belgian regulators, close European neighbours, found themselves pulling in different directions. Another well-known example is Lehman's, where American hopes for a rescue by Barclays were frustrated by the British regulators' reluctance to have one of their banks take on liquidity requirements that were unquantified.[1]

But the best example of which I have direct experience is the takeover of ABN AMRO by Royal Bank of Scotland (RBS)/Fortis.[2] This case shows the need for a better model of collaboration and coordination between regulators, including the need to communicate and pick up incipient signs of distress, and to take action in a truly united and timely fashion. When the bid discussions were announced, in April 2007 and in competition with an existing bid from Barclays, the crisis was just developing. Its full dimensions were not recognised, but the largest US sub-prime lender had already failed; and during the bid process we saw the collapse of two Bear Stearns hedge funds, the rescue of Countrywide and the run on Northern Rock.

When Fortis joined RBS and Santander to form a consortium to take over ABN AMRO, the four regulators involved started to examine the implications for their respective countries' banking systems instead of working together in a joint effort, as should have been the case from day one.

The banks on the commercial side had some serious restrictions in committing to a **full** due diligence. RBS could not perform a full due diligence due to the prevailing market practice in the United Kingdom and the Netherlands, and could not determine the quality of assets in ABN AMRO's structured credit portfolios or the valuation of those positions. But that is the commercial side of the coin.

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[1] See, for example, the UK Financial Services Authority (FSA)'s evidence to the US bankruptcy Examiner: www.fsa.gov.uk/pubs/other/lehman.pdf.
[2] A brief history of the takeover, with key dates, may be found at: http://finance.practicallaw.com/0-381-3289#a793916.

On the regulatory side, much more information was available; and it is imperative that a regulatory model allows the full body of information to be shared and discussed among the regulators.

Did the Dutch Central Bank know, as the UK Financial Services Authority (FSA) knew, that the RBS stake in the takeover – 38% – represented 61% of RBS's reported Tier 1 capital? [3] Conversely, did the FSA know about the volume of mortgage-backed securities, many of them just above sub-prime, on ABN AMRO's books?[4] Did the Dutch know in full the critical ratios of Fortis as known by the Belgian regulator?

Did the four regulators at any time from the start of the consortium offer in October 2007 confer with each other so that their collective response could be founded on a deep understanding of the potential implications for each bank and its banking system?

Furthermore, the expectations, roles and responsibilities of each regulator were not mutually understood and agreed. The FSA thought that the strategy, business model and key business decisions were matters for boards,[5] while the Dutch Central Bank was tainted and hindered by association and comparison with the Italian Central Bank's role in the takeover by ABN AMRO of Banca Antonveneta the previous year. The political intervention by the Dutch, who accused the Italians of bias and protectionism, naturally led to similar accusations being levelled against the Dutch Central Bank in its dealings with ABN AMRO a year later.

A further issue was the reluctance of regulators to recognise the full dimensions of the crisis into which they were heading. Dutch regulators were too sanguine about the quality of ABN AMRO's assets, and so failed to recognise the potential problems. At other points – which I cannot discuss in detail – regulators did not question the financial standing of certain major institutions, despite the fact that other well-known names were already in trouble. Regulators above all need to be sceptical, and ready to think the worst.

In addition, the question arises: To what extent could individual regulatory responses have a destabilising effect on the market if the market reads too much into a regulatory intervention? When, during a developing crisis, a large bank makes an offer, which is then followed by regulatory action being taken, could that action be based on major concerns from the regulator about the capital and liquidity position of the bank? If the

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[3] *The failure of the Royal Bank of Scotland: Financial Services Authority Board Report*, www.fsa.gov.uk/static/pubs/other/rbs.pdf, paragraph 335.
[4] ibid, paragraphs 380–386.
[5] ibid, paragraph 420.

market believes it could, might it not itself cause the negative effect that the regulator is trying to avoid?[6]

So, the role of the regulator is very difficult in these kinds of circumstances. Any particular regulator is likely to have incomplete information, its roles and responsibilities may be unclear, and there will be political pressures, as well as pressure to be impartial – which is very much in the eye of the beholder.

This case shows that only close cooperation and joint approaches/information sharing will help in avoiding mistakes that ultimately might have contributed to the downfall of both Fortis and RBS.

In the aftermath of the global financial crisis, the standard setters, led by the Financial Stability Board (FSB), have attempted to define more closely the responsibilities for group supervision, the arrangements that should apply in a crisis, and the legal regimes that should underpin them. One recent example was the FSB's publication in November 2011 of its "Key Attributes of Effective Resolution Regimes for Financial Institutions".[7] However, none of these arrangements has yet been tested in the fire, and it remains to be seen how far they will help. Personally, I believe that a huge amount will still come down to relationships between regulators. It is also important to note that, in general, the new arrangements address issues at the firm or group level. They do not address contagion spreading from institution to institution, each with a different international profile. Nor do they address crises that are essentially economic – for example, how financial services regulators would behave if the Eurozone were to fragment.

What are the issues here for Islamic finance specifically? I start from the consideration that most Islamic institutions are relatively small. There are some systemically important conventional firms with Islamic windows or subsidiaries, but among predominantly Islamic firms few will be systemically important even at the national level. Most do not have a strong multinational presence. In addition, Islamic securities firms have, for these purposes, a great deal in common with conventional firms. They may, of course, be caught up in a crisis – for example, if a central counterparty were to fail – but the handling of it for Islamic firms would be very similar to that for conventional ones.

Where a crisis involving an Islamic institution can be handled at a national level, the issues are essentially technical, though difficult. The first, for the banking sector in particular, is how to provide liquidity in a *Sharī`ah*-compliant way, and against acceptable security. This is an issue to which many authorities, including the Islamic

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[6] This was certainly a concern to the FSA: ibid, paragraph 426.
[7] www.financialstabilityboard.org/publications/r_111104cc.pdf

Financial Services Board (IFSB), have devoted considerable attention, and I do not intend to spend time on it here. Authorities may also need to take steps to prevent a run. One element of this is a deposit protection scheme, which can help forestall panic by retail customers at least. In the case of an Islamic bank, it will need to be clear what such a scheme covers. If the regulator takes the view that profit-sharing investment account holders must, in *Sharī`ah*, remain exposed to the risk of loss, and therefore should not be covered, they will of course have every incentive to withdraw their funds in a crisis. And if the regulator leaves the question unclear, then the prudent investor will, again, withdraw his or her money as soon as rumours start to circulate.

Further issues arise if supervisors need to go beyond short-term liquidity provision to resolve a failing institution. A straightforward "white knight" takeover involving the purchase of the whole institution will not be problematic. But in a real crisis, a white knight may be difficult to find because of the uncertainties and the limited due diligence that can be done. In such a situation, in banking, one approach will be to try to transfer at least retail deposits to another bank, and to buy some time to resolve other parts of the book. The FSB proposals on resolution envisage the alternative approach of a strong resolution authority, which can seize the institution, continue its operations in the short term, sell or transfer elements, force some bondholders or creditors to accept losses, and so on. Such a structure will need to have a solid foundation in law, because when people are in danger of losing large sums of money, some of them will mount any legal challenge they can. This may go beyond their own contractual relationship with the institution. For example, a creditor that stands to lose may well challenge the basis on which potentially profitable business was transferred to another institution.

In the case of Islamic finance, this means that the nature of each party's relationship with the institution needs to be crystal clear. For example, a person that has placed money with the institution under a *Murābahah* contract has, in *Sharī`ah*, a direct creditor relationship with the bank; he has sold some commodities to the bank on credit. But one that has placed it under *Muḍārabah* or *Wakālah* does not; he has placed money to be invested on terms under which it is at risk, but has a claim to a share of the assets in which it has been invested. Is this the position that the courts will take? And is it clear enough to those involved that supervisors can withstand the political pressure of those who claim not to have understood that their funds were fully at risk?

Broadly similar issues would arise, though typically in slower motion, in trying to resolve a failing *Takāful* undertaking. For example, can the *Takāful* fund, which in principle belongs to the policyholders, be transferred with all its policyholder relationships into a new operator that is willing to continue the business? If so, what becomes of any shareholders' funds remaining in the old operator? Can the regulator force these to be paid to support the *Takāful* fund, and if so, to what extent? How does any need to

support this fund rank in relation to the operator's other obligations – for example, to its staff?

Any legal uncertainty is also likely to give rise to private litigation. This may take unexpected forms. For example, when The Investment Dar, from Kuwait, was in difficulty, it found itself fighting Blom Bank, from the Lebanon, in an English court, and trying there to repudiate a contract on *Sharī`ah* grounds.[8]

Issues like those I have described are important even if no case ever comes to court, because the legal position often underpins the negotiating position. If the supervisor is trying to negotiate a deal to resolve a troubled institution, the parties' negotiating positions are likely to be underpinned by what they believe they would get in an alternative scenario. I do not believe that any of these issues is insoluble. But I believe there is more work to be done on them, and that this should be done ahead of any crisis.

When a crisis becomes international, life becomes much more complex. First, as I have already suggested, in a crisis the natural tendency of every supervisor is to protect its own jurisdictional interests. This can manifest itself in an ugly scramble to grab the assets first and argue afterwards. Even if this can be avoided, the firm may well have moved assets around the world to try to shore up its position; we saw this with both Lehman's and AIG. There is nothing peculiar to Islamic finance in this, but it means that issues need to be played out in the legal systems of multiple jurisdictions. This will remain true even if a local operation is nominally separate, and if Islamic business is conducted through a subsidiary rather than a window. The issues will also be played out between supervisors with different knowledge of Islamic finance, and possibly different views of it. For example, two supervisors may differ about whether an intragroup placement creates a debt between one company and another. Or, in the context of rescue negotiations, they may differ about the basis and terms on which a *Takāful* operation could be sold.

Sharī`ah governance is a further complication here. This is, of course, an important underpinning of the normal operations of an Islamic firm. But how will it work when the firm and its supervisors are negotiating the terms for its own survival? Those of us who have lived through crises are used to teams of lawyers negotiating through the night, while the boards of the firms are in continuous session, and teams of accountants crunch the numbers. Will there also have to be teams of scholars meeting? Is this possible, given the multiple commitments of the leading scholars, and how will any cross-jurisdictional differences be resolved?

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[8] See www.bailii.org/ew/cases/EWHC/Ch/2009/3545.html.

The good news is that any single institution that is significant and complex enough for cross-border resolution to be a serious issue should already have its own college of supervisors. If it does not, we have a collective responsibility to make sure it does. Colleges inevitably, and rightly, focus mainly on the current risks, but the FSB is pressing them also to consider the issues of resolvability. I suggest that one of our duties as supervisors of Islamic finance is to ensure that these discussions take account of the Islamic dimension. We need to educate our colleagues, and ensure that the particular features of Islamic finance do not come as a surprise in a crisis.

But we also need to do work among ourselves. Otherwise, we risk repeating the same thinking in each supervisory college, and getting different answers depending on which supervisors are represented there. One starting point might be for some of our staff to meet for a couple of days to run an intensive scenario exercise, based on a real crisis but with an Islamic dimension.

Finally, I have so far spoken about single-firm, or at least single-group, crises. I have said very little about sector-wide crises or contagion issues. This reflects the fact that the shape of any such crisis is very difficult to predict. No one, in either the conventional or the Islamic world, has defined how a multi-firm crisis would be handled, simply because that depends too much on which firms are involved and how they are linked. All one can confidently say is that the complexities will multiply as different groups of supervisors and other professionals interact, typically trying to protect the interests of one firm against others, and as political authorities become involved, as they inevitably will.

In summary, therefore, I have sketched a number of questions that need further work. Whereas in conventional finance the issues are mainly about how to prepare for and manage a crisis within largely known legal parameters, in Islamic finance there is real uncertainty about those parameters, and how they will operate in a crisis. We need to do more work among ourselves to address these questions, to achieve as much consensus as possible, and to share it with conventional regulators. In the meantime, we can still make progress with our own resolution regimes, along the lines recommended by the FSB – and, of course, try to ensure that the next crisis is a long way off.