



HARVARD LAW SCHOOL
Islamic Legal Studies Program

and



LONDON SCHOOL OF ECONOMICS

Workshop on
*Insolvency & Debt
Restructuring in
Islamic Finance*

Thursday, February 28, 2013

London School of Economics
Tower #3, 5th Floor (BOX)
London, United Kingdom

**Harvard Law School
Islamic Legal Studies Program
&
London School of Economics**

Workshop on

Insolvency and Debt Restructuring in Islamic Finance

**Thursday, February 28, 2013
8:30a.m--5:30p.m.**

**London School of Economics
Box Room, 5th Floor, Tower #3
London, United Kingdom WC2A 2AE**

Directions: <http://www.lse.ac.uk/resources/mapsAndDirections/findingYourWayAroundLSE.htm>

OVERVIEW

Last year participants chose “Islamic Financial Intermediation: Revisiting the Value Proposition” as the topic for the 7th annual Harvard-LSE workshop. This 'back to basics' exercise emerged from a sense that the industry should review the directions it had been taking since the global economic downturn.

This year, as the topic for our 8th annual workshop, participants overwhelmingly have chosen to focus on the Islamic finance sector's handling of insolvency and debt restructuring scenarios. The global economic and financial downturn has forced actors in this sector to face many challenging legal and regulatory issues, both Islamic and secular -- issues such as how to unwind, restructure or enforce particularly the *shari'a*-compliant structures and entities that had been innovated and developed over the last decade.

These challenges were compounded by the absence of sophisticated insolvency regimes and regulations, and by various rulings by non-Islamic courts on technical Islamic concepts, structures and principles. Also, events highlighted how, after all, the classical Islamic law addresses only the insolvency and defaults of individuals, and not those of sophisticated corporate enterprises and SPVs. Some of the more widely reported debt repayment failures in this sector include:

- i) The Investment Dar default, a *sukuk* offering with heavy reliance on short term debt;
- ii) East Cameron Gas – poor credit risk; court deciding the issue whether a 'true sale' of the assets occurred (issue of “asset-backed” versus “asset-based” *sukuk*);
- iii) The Saad *Sukuk*, a *sukuk* collapse following allegations of financial fraud;
- iv) The ‘near default’ of the Nakheel *Sukuk*, involving debt-restructuring following state intervention and issuance of hastily-drafted new insolvency laws.

Defaulting products and institutions have raised many valid queries, such as the extent to which one class of creditors may claim preference over another class, priority over others in recourse to assets (asset-backed versus asset-based *sukuk*), whether GCC regulatory regimes can adopt Chapter-11-style debt restructuring, *shari'a* issues pertaining to cross default and acceleration of future loans, and whether to uphold the limited liability of corporate entities versus 'piercing the corporate veil' and claiming against their individual shareholders.

INTRODUCTION

Islamic law lays down rules for *iflas*, the condition of being unable to pay one's debt (insolvency), and for *taflis*, the official act or procedure of declaring the person *muflis* or insolvent. Debt restructuring, defaults, triggers for events of default, cross default, debt acceleration and debt suspension mechanisms such as US Chapter 11 proceedings are all relatively new concepts to Islamic law.

This workshop aims to discuss how to achieve a morally sound balance between debtors' and creditors' rights in Islamic finance.

Questions to be addressed include, first, what we mean by the concepts of insolvency and debt restructuring within modern Islamic finance; second, what specific transaction-types, structures, mechanisms or institutions are needed to help the industry address new challenges in this sphere; and finally, what needs to be done, if anything, to readjust the current trajectory of the industry with respect to insolvency scenarios and defaults.

In September 2011, the Harvard Islamic Finance Project sponsored a panel discussion at Harvard Law School on the subject "Bankruptcy, Financial Distress and Debt Restructuring in Islamic Finance." To start discussion at this workshop, a brief report on that panel discussion has been circulated to all workshop participants. Also, as in previous years, each participant has been asked to provide comments prior to the workshop discussion, and these have been circulated. The purpose again being to allow us to launch our discussion at a more focused, further advanced level.

We hope that this preparation will enable us to spend more time discussing deeper level questions, such as what socio-economic and legal principles Islamic law can contribute for handling defaults, insolvency and debt restructuring scenarios in a modern financial system, in particular with respect to Islamic finance.

Also, in line with earlier workshops – which took up one or another case-study not only for its own importance but also to facilitate discussion of deeper issues confronting the industry generally – we hope that one of the outcomes of this workshop will be to elicit and articulate key new recommendations on how to move the industry forward generally, and not only in the contexts of insolvency or economic and financial crisis.

OBJECTIVES

In this workshop, we would like to examine the topic from five levels:

- i. Defaulting *individuals*;
- ii. Defaulting *corporate transactions* (insolvent corporate borrowers; *sukuk*);
- iii. Distressed *financial institutions*;
- iv. National and cross-border bankruptcy and insolvency *legislation, rules and regulation*; and
- v. Islamic finance *industry bodies* (e.g., standards, model laws).

We intend to achieve following objectives during this workshop for each of the aforesaid five levels:

1. Reviewing the understanding of the Islamic insolvency and debt restructuring pendulum with respect to creditors' and debtors' rights.
2. Testing our understanding of how modern regulatory regimes have handled financial defaults and how they have applied Islamic legal concepts and principles.
3. Discussing and applying Islamic financial insolvency concepts .
4. Discussing potential immediate economic, legal and regulatory reforms required to better deal with the complexities involved in defaults of contemporary Islamic finance products and institutions.
5. Exploring any new guiding principles or processes for development emerging from our discussion that might help the Islamic finance industry in its quest for a more sustainable future.

WORKSHOP AGENDA

8:30 a.m.

Reception and Coffee

9:00 a.m.

Opening Remarks by Professor R. David Kershaw, London School of Economics

9:10 a.m.

Introduction by Workshop Moderator, Frank E. Vogel

Part 1: Macro Overview of Insolvency

9:30 a.m.

Presentation of *Macro* Insolvency Concepts

A brief discussion on the *macro*-level issues raised by Islamic finance in insolvency and debt restructuring scenarios.

9:50 a.m.

Participants' Views – Open Floor Discussion

Opportunity for each participant to explain briefly their views on the following questions:

1. It is clear there are challenges in reconciling Islamic finance concepts with modern legal and regulatory regimes. These challenges lead to added costs, inefficiencies, inconsistent results, uncertainty, and reduced confidence. Some jurisdictions are better equipped than others to deal with the multitude of technical, legal, social, and religious considerations as an insolvency situation advances. So, should Islamic finance:
 - a. Develop its own set of insolvency rules and regulations which can be universally applied in all jurisdictions? If yes, where do you start from? Which model should be used? What would be the unique aspects of this model distinguishing it from others? How would it be established and implemented?

OR

- b. Continue to use the existing patchwork of legal structures and simply address each technical hurdle at each of the relevant levels on an ad hoc basis? If this option is chosen, how should we address each such hurdle? Given the issues of moral hazard and irreconcilable cross-

jurisdictional issues, should/can we insist on special guidelines for Islamic finance industry? Can we really impose moral and ethical conduct on an inherently secular-based legal system? What about consumer and employee education?

2. How did the industry generate legally valid financial structures that could not be unwound in an orderly and proper way? Who is to blame? If no one, is this an acceptable risk the investors must simply assume and price in?

11:00 a.m.

Tea/Coffee Break

11:20 a.m. **Summary** – Moderator to provide a summary of all the points of view and frame questions.

Part 2: Macro Overview of Insolvency Issues - Testing the Scope

11:25 a.m. **Participants' Views – Open Floor Discussion**

Opportunity for each participant to explain briefly their views on the following questions:

1. If Islamic finance is meant to be fair, equitable and just, how are these concepts manifested in modern insolvency situations? Are the products delivering fair, equitable and just results in insolvency scenarios?
2. If modern Islamic financial intermediation is simply a *shari'a*-compliant version of conventional financial institutions and product offerings, is it not about time we give up once and for all any claims that Islamic finance mechanisms should differ in insolvency situations from regular conventional debts or bonds? If not, then how does or should Islamic finance differ in such situations?
3. How can modern insolvency regimes be enhanced to meet the current needs of Islamic finance and its application?

4. How can Islamic finance enhance insolvency regimes to reduce or prevent:
 - Consumer ignorance?
 - Moral hazards?
 - Lack of enforcement?

12:45 p.m.

Lunch

1:30 p.m. **Summary** - Moderator to provide a summary of all the main points of view.

Part 3: Discourse on Applied Islamic Finance – Micro Overview of Insolvency Issues

1:50 p.m. **Presentation of *Micro* Insolvency Concepts**

A brief discussion on the *micro*-level issues raised by Islamic finance in insolvency and debt restructuring scenarios.

2:00 p.m. **Participants' Views - Open floor Discussion**

1. For each of five levels [i.e., i) defaulting *individuals*; ii) defaulting *corporate transactions* (insolvent corporate borrowers; *sukuk*); and iii) distressed *financial institutions*]:
 - a) What aspect of modern Islamic financial insolvency practices needs to *change* in order to achieve better outcomes?
 - b) What aspect of modern Islamic financial insolvency practices needs to *remain* in order to achieve the best outcome?
2. For each level, what are the specific economic, legal and regulatory reforms that should be put in place?
3. How can individuals and lower-income consumers access proper insolvency and restructuring regimes, if there will always be high risks, high costs and enforcement problems preventing their effective implementation?

3:00 p.m.

Tea/Coffee Break

3:15 p.m.

Summary - Moderator to provide a summary of all the points of view

Part 4: Way Forward

3:25 p.m.

Open Floor Discussion

If you had the authority to do so, and knowing what you know now, how would you improve the current framework of insolvency regimes? With respect to Islamic finance transactions, how would you enhance insolvency and debt restructuring outcomes?

Participants to discuss—and, where possible, reach consensus on—points or issues within areas to be raised by the Moderator.

Part 5: Future Workshops

4:15 p.m.

Action Plan – Participants to assist the Moderator in drafting a workshop summary including suggested solutions.

Forthcoming from Edward Elgar Publishing

The *Tawarruq* Debate in Islamic Finance

Edited by Frank E. Vogel

Associate Editors: S. Nazim Ali, and Umar A. Oseni

A fundamental departure from conventional interest-based financial systems, Islamic finance has appeared on the global scene as a principle-based system that has over \$1.3 trillion Shari'ah-complaint assets across the world. Such notable growth within a short span of time has been characterized by some controversial transactions, including organized *tawarruq* or commodity *murabahah*, *Bai Bithaman Ajil*, and *Bai al-Inan*. This pioneering book examines different perspectives on *tawarruq* as a debt instrument in Islamic finance. Drawing from the high-level discussion of Shari'ah scholars, Islamic economists and financial experts at the annual Harvard-LSE workshop, the book comprises thirteen chapters dissecting the dynamics of *tawarruq*, from the classical period to modern times. It also includes discussion of the recent restrictions on *tawarruq* by the Central Bank of Oman.

The chapters are written by leading figures in the Islamic finance industry, including: Muhammad Taqi Usmani, Hussain Hamed Hassan, Mohammad Nejatullah Siddiqi, Mabid Al-Jarhi, Muhammad A. Elgari, Nazih Hammad, Nizam Yaquby, Mahmoud A. El-Gamal, Sami Al-Suwailem, Mufti Barkatulla, Salah Al-Shalhoob, Ali Adnan Ibrahim, and Umar A. Oseni

All of the editors are affiliates of the Islamic Finance Project, Harvard Law School, US.

Islamic Finance, Accounting and Governance series

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NOTES

First Capital United

www.firstcapital.com

Capital Funding Group

www.cfbg.com

MAFIC International (American Islamic Investment Co.)

www.mafic.com

National Commercial Bank

www.natcombank.com

NOTES

The Taxing Debate in Indiana History

Edited by Frank E. Vogel

Indiana University Press, 1964

A historical approach to taxation in Indiana is given in this book. The author, Frank E. Vogel, is a professor of history at the University of Indiana. The book is a collection of essays, some of which were published in the *Indiana Historical Review* and others in the *Indiana Magazine of History*. The book is a valuable contribution to the history of taxation in Indiana.

The book is divided into two parts. The first part, "The History of Taxation in Indiana," contains five essays. The second part, "The History of Taxation in Indiana," contains five essays.

The book is a valuable contribution to the history of taxation in Indiana.

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