The Bankruptcy of an Islamic Financial Institution: A Case Study of Islamic Bank Limited (IBL)

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Abstract

In modern era, the financial modes have gotten new shapes. An endeavor has been undergone to practice the Islamic modes of finance i-e Mudarabah, Musharaka ,Ijara, Istisna (استصناع) and Murabaha. Majority windows for launching these modes.

Similarly, severed banks have been established for the purpose of Islamic finance only many observations have been put challenging the legitimacy of these modes, which are being resolved by the Islamic economic experts.

The conventional bank IBL has been facing bankruptcy for not fulfilling the sharia guideline in many ways.

We have focused on the causes that are responsible for the situation and have offered the real Islamic perspective regarding the various financial transaction.

Key words *:Finance, Bankruptcy, Mudarabah, Ijara*

1.1 Background

Islamic financial institutions were relatively more resilient during the 2008 financial crisis. However, there are some examples of insolvencies in Islamic finance, taking place after the global financial crisis and well before that, which can be looked into to derive some lessons about insolvency and bankruptcy in the Islamic finance context. Such cases may help in juxtaposing the ground realities of Islamic finance with its ideals that may guide about the possible future insolvency scenarios. It may also help us find out what can be done to bridge the gap between the ideal and real worlds of bankruptcy by comparing the classical Islamic insolvency law with contemporary trends and practices.

The need to address insolvency and bankruptcy in the context of Islamic finance is specially highlighted in the post global financial crisis literature pertaining to Islamic finance. Even before the crisis, concerns existed due the replacement of

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equity-based Islamic banking model with the debt based banking structure, albeit viaSharīʿah compliant contracts.

Murābaḥah became the dominant activity of Islamic banks and debt, therefore, came to assume a greater role than was initially anticipated. Still, mainly due to its short history, modern Islamic finance paid little attention to insolvency and its consequences. But as the global financial crisis deepened and its effects reached the real sector of the economy, questions were raised as to how the existing bankruptcy and insolvency regimes, both in and outside the Muslim countries, will address Sharīʿah compliant transactions in the case of insolvency? The issue was further highlighted by instances of *ṣukūk* failures and quasi-failures, which brought to the fore matters of insolvency and bankruptcy in relation to Islamic financial institutions.

Thus, it should not come as a surprise that institutions like World Bank, Islamic Financial Services Board, Accounting and Auditing Organization for Islamic Financial Institutions and the Fiqh Academy of the Organization of Islamic Cooperation have addressed this issue in the wake of global financial crisis. Although the literature on this issue is scarce, the discussions by these institutions have produced some good food for thought and further research. Consequently, researches have been undertaken to evaluate different aspects of this topic. Though the progress of the research is currently slow, it is expected to gain momentum with the passage of time.

1.2 Bankruptcies in Islamic Finance

In spite of its recent emergence and short history, instances of Islamic banks going into distress and even collapse have been cited in the literature. For instance, Kuwait Finance House suffered heavy losses in 1984. Whereas Grais and Pellegrini (2006) ascribe these losses to the crash of Souk al-Manakh, Nienhaus (1986) attributes them to large exposure to construction industry.

Similarly, the Islamic International bank of Denmark lost more than its 30% of equity between 1985 and 1986 which is attributed to heavy exposure to one borrower and excessive risk taking (Grais and Pellegrini, 2006). Ihlas Finance House was shut down in Turkey in 2001 on the grounds of financial distress and liquidity problems. The same year saw the closure of Bank Taqwa. Faisal Islamic Bank also had to close its operations in UK for regulatory concerns. Whereas the causes of failure in Islamic banks may be the same as those in conventional banks, Islamic banks do suffer an extra loss with their downfall; not only the progress to move towards an alternative system of interest-based mechanism is slowed down, it also damages the reputation of the nascent industry (Ali, 2007).

The instances when Islamic banks have been in trouble provide questions for deliberation. The behavior of the parties to banking environment during these episodes is surprising and sometimes contrasting. One example should suffice as evidence. The first Islamic bank of Malaysia, Bank Islam Malaysia Berhad (BIMB) incurred losses of RM457 million in the year 2005 mainly due to a RM774 million provision against bad loans and similar investments. The gross non-performing loan portfolio of the bank was about RM2.2 billion most of which had been incurred by the bank's Labuan branch. Although the reasons for these losses had not been sufficiently revealed according to many, the central bank of Malaysia took immediate and effective steps and was able to bring BIMB out of its troubles in short time. The recapitalization of BIMB completed by October 2006 and it was able to deliver a net profit of RM253.68 million during the first nine months of the financial year 2007/08 (Wright, 2008).

This episode of successful emergence of an Islamic bank from its distressed situation is in total contrast to the closure of Ihlas Finance House in Turkey in 2001. In contrast to the supportive role played by the central bank of Malaysia, the only initiative taken by the supervisory authority in the case of Ihlas Finance House was the closure of the bank abruptly, causing serious problems for the rest of the industry players that we shall elaborate in detail later.

An important question regarding the failure of Islamic banks is that why these institutions fail when they operate on the basis of profit and loss sharing? This question simply reflects the contradiction of real and ideal in the context of Islamic finance which has produced much criticism. Theoretically, Islamic banks are supposed to have two types of deposits from their customers; demand deposits and investments deposits. In contrast to demand deposits which are loans from depositors to the bank and are fully guaranteed, the investment deposits or profit related to them are not guaranteed and their outcome is supposed to be dependent on the asset side performance of the Islamic bank. These investment deposits constitute the bulk of Islamic banking liability side which is then converted into a mix of fixed return contracts and profit and loss sharing contracts. This ideal picture was supposed to give Islamic banks more stability because these banks would shift investment losses to their depositors on the basis of profit and loss sharing principle.

Contrary to this ideal picture, Islamic banks today find an unsupportive environment and infrastructure that is suitable for borrow and lending practices only. Consequently, they have to rely on fixed return contracts, like *murābaḥah* etc., more instead of the ideal two tier *muḍārabah*. It makes the assets of Islamic banks fixed return and exposes them to various risks that lead to their instability and failure.

However, it does not mean that if Islamic banking is fully based on profit and loss sharing model, it will be crisis-proof. Insolvency and bankruptcy may still happen. It is a well-known principle in Islamic jurisprudence that *muḍārib* is not liable for the losses incurred during *muḍārabah* venture. However, he is liable for such losses in the case of negligence and misconduct etc. The case study below will show how an Islamic bank can be negligent when its deposits are based on *muḍārabah* and, thus, go bankrupt.

1.3 An Introduction to Islamic Bank Limited (IBL)

The first Sharīʿah complaint bank in South Africa, Islamic Bank Limited (IBL) was granted bank status in 1988. Its attempts to obtain banking license were mainly private and backed by positive community responses. Since Islamic banking was not tested in the market by then, concerns were raised by the regulators. However, the conditional (restricted) license grant was taken as a test case for introducing Islamic finance in the country.

Being a new entrant into the market with the passion to market a novel banking idea, IBL had the responsibility to uphold Sharīʿah ethics along with the prudential regulations while being a custodian of the funds of the depositors (Nathie, 2010). On the contrary, it took IBL only one ten years to collapse in 1997 with R50 million to R70 million of debts owed to depositors majority of whom consisted of Muslim savers who intended to save money for performing pilgrimage.

In general, bank failures in South Africa have not been uncommon and researchers have attributed these failures to many causes. For instance, Okeahalam (1998), Okeahalam and Maxwell (2001) and Manuel and Mboweni (2002) attribute such failures to fraud and insider lending. Examples include the failure of Alpha Bank, 1990; Cape Investment Bank, 1991; Islamic Bank of South Africa, 1997; Regal Treasury Bank, 2001; and Saambou Bank, 2001. On the other hand, Ngaujake (2004) identifies liquidity runs and poor management to be responsible for the collapse of Pretoria Bank, 1991; Prima Bank, 1994; African Bank, 1995; and Board of Executors, 2002, as well as the Islamic Bank of South Africa, 1997.

1.3.1 Causes of IBL Collapse

Okeahalam (1998) counts a number of factors that played a role in the collapse of Islamic Bank of South Africa. These include: bad management, improper management and accounting systems and large insider unsecured lending that resulted in higher proportion of non performing balance sheet assets. Nathie (2010) argues that while IBL had become insolvent by the end of September 1997 mainly due to insider and unsecured lending, no provisions for non-performing and non-recoverable debts were disclosed in the published accounts; the non-performing loans constituted 30.3% of the total advances whereas only 44.5% loan advances were supported by credible securities.

Small party exposure was also alarming; management and family related loans ratio was 36.7% as at liquidation date. These advances were not collected for up to four years before collapse.

However, the role of the central bank of South Africa, Reserve Bank (RB), has been particularly criticized by Mashele (1997). If compared with some earlier failure cases, RB procrastinated to take timely actions and the delay aggravated the situation further (Nathie, 2010). In addition, RB decided to compensate depositors of IBL up to a maximum amount of R50, 000. However, it meant that only 80% of the depositors will be fully compensated. This partial compensation by RB, which led to many case filings by the depositors, and its inability to manage bank failures efficiently indicate the haphazard management by the regulator. Undue political pressure might have been responsible for delayed actions on the part of RB (Okeahalam, 1998).

Nathie (2010) argues that the failure of Islamic Bank Limited is a good example of how loss of confidence, rumors and uncertainty can precipitate a run on the bank by depositors. It is well evidenced that depositors cannot differentiate between good and bad banks during such runs which is well manifested through the case of IBL: "Associated with this failure was the seriousness of the bank run on *muḍārabah*-contracted deposits first occasioned by noise, then opaque operational information, lack of confidence and finally contraventions of law, dodgy accounting, poor operational practices and Sharīʿah non-compliance" (p. 8). Thus, the collapse of IBL can be attributed to more than one reason some of which are discussed next.

1.3.2 Sharīʿah non-Compliance Activities in IBL

Apart from the irregularities unrelated to Sharīʿah compliance as listed above, a list of Sharīʿah non-compliance activities related to the products offered by IBL has also been documented in the literature. These activities are summarized in the following table (Nathie, 2010, p. 21):

Table 1: Selected cases of Sharīʿah product non-compliance

Product type	Non-compliance
Deposit accounts	
Amanah Funds (custodial)–only to be used 'as directed'	Covenant not adhered to as funds were mixed with normal deposit accounts
Muḍārabah deposits	*Rabb al-māl* liable for losses but losses not allocated to depositors Losses due to negligence not absorbed by bank
Finance products	
Murābaḥah contracts	Used in bill discounting
Short-term *muḍārabah* contracts	No contracts in place
Long-term *muḍārabah* real-estate contracts	Convoluted transactions. Interposed entity used to buy property not controlled by IBL. Real estate then on-sold to related parties using conventional *ribā* contracts

This list of Sharīʿah non-compliance activities leads to a question; since IBL had a Sharīʿah Advisory Council (SAC) to observe its compliance with Sharīʿah, how could such violations occur? Although serious concerns have been raised regarding the role of Sharīʿah advisors, at least in this case the SAC did advise IBL and raised a number of non-compliance issues from time to time. However, these concerns did not stop the non-compliant activities of IBL because they were only related to compliance of the products and not to violations of law. For instance, SAC warned IBL of these breached as early as 1991. Later in March 1992, it expressed its serious concerns about IBL's non-compliance of product as well as profit distribution.

In September 1995, SAC expressed that it preferred to directly deal with management regarding Sharīʿah breaches in order to avoid negative public signals. However, SAC was aware of its duty towards other stakeholders like shareholders, creditors, depositors and Islamic community in general. In November next year, SAC reminded IBL about the general disappointment of the Muslim community due to its Sharīʿah non-compliant practices in lending. Even at one stage, SAC had withdrawn its Sharīʿah approval in 1993. But contrary to all these signals by SAC, IBL was more than contended with its performance and activities as shown in some of its statements:

> *"...we are pleased to report that the Islamic Bank has successfully restored its deposit base and liquidity." (Nathie, 2010, p. 23)*

It seemed that financial performance was more important for the management than compliance with Sharīʿah. With multiple reasons behind this failure of IBL as listed above, the consequences were multiple and sever in nature. Loonat (2004) describes it as a reputational blow to the nascent Islamic finance attempts in South Africa. The failure was, however, not due to a failure of faith but of prudent management and governance practices. At the beginning of the panic, the management assured the depositors that their deposits were safe which was contrary to the fact. Besides, in contrast to its claims of Sharīʿah compliance, the ethical charter and public image of IBL, the bank was involved in *ribā* based property debts (Nathie, 2010).

1.4 Important Lessons in IBL Collapse: Lender of Last Resort, Deposit Insurance and Operational Risk

Apart from issues related to reputation, there are three important issues embedded in IBL failure that have been summarized by Nathie (2010): the role of central bank as the lender of last resort (LOLR), deposit insurance and upholding the principles of Sharīʿah.

The first issue is the role of central bank, in this case RB, in restoring liquidity of the troubled banks. It should be noted that LOLR is a key concept in the stability of financial system as a whole. Usually, it is the central bank of the respective government that undertakes the role of lender of last resort.

For instance, in the case of the collapse of Masterbond which was a mortgage finance company, RB provided an interest free loan of R1.1 billion secretly which was only known at later stage. Unfortunately in the case of IBL, the role of LOLR was not played well by RB. Unlike the previous cases in which RB did provide aid to some institutions in difficulty, IBL was not offered this support which might be due to IBL's violation of regulatory and other aspects of its responsibilities.

However, the concept of LOLR has not been well developed in the context of Islamic finance due to the recent emergence of industry and lack of practical examples in which Islamic financial institutions needed this facility. According to Chattha and Halim (2014), there are four possible structures of Sharīʿah that can be used for Sharīʿah-compliant lender of last resort (SLOLR) as opposed to the simple interest based LOLR in conventional finance. These include: *qarḍḥasan* SLOLR mechanism, commodity *murābaḥah* transaction SLOLR mechanism, *muḍārabah* SLOLR mechanism and *wakālah* SLOLR mechanism.

The writers argue that this concept is not totally alien to Islamic law when observed from the perspective of *maqāṣid al-Sharīʿah*, *qawāʿid al-fiqhiyyah* and *al-siyāsah al-Sharʿiyyah*. However, since IBL operated in a non-Muslim jurisdiction, there was no question of LOLR being discussed from Sharīʿah perspective.

Deposit insurance is the second issue highlighted in IBL collapse. As elaborated earlier, RB announced to compensate depositors up to an amount of R50, 000. Since majority of the IBL depositors were individual Muslim savers who aspired to go for pilgrimage, this coverage was enough to refund 80% of them. However, not covering all the depositors led to many lawsuits in the days to follow. It shows that there was mismanagement by RB with respect to handling this issue (Okeahalam and Maxwell, 2001). But in general terms, deposit insurance has problems of its own, notably moral hazard. Examples of the banks' failures around the globe show that banks are prompted to take excessive risk because of deposit insurance (Marinc and Vlahu, 2012). Thus, deposit insurance remains problematic for Islamic financial institutions (Nathie, 2010).

The third issue in this context is the serious operational risk. Recently, operational risk has attracted the attention of regulators (Archer and Haron, 2007). Although it carries many regulatory concerns, the most serious one is "material malfunctioning" that was detected in the operations of IBL too. Material malfunctioning has been elaborated by Wiese (1997) as:

> *A breakdown in, and overriding of, a non-existence or an inadequacy of a control procedure system: which has resulted in, or had the potential to result in, material losses, contingencies or uncertainties; where 'material' means anything that would influence the correctness of the value or classification of any asset or liability, or the correctness of the annual financial statements or any statutory return, by more than a threshold (where the threshold is either a fixed amount specified, or a percentage of some factor such as net shareholders' funds or profit after tax). (p. 4)*

Different aspects of material malfunctioning in IBL have already been discussed earlier.

1.5 Some Sharīʿah Issues in IBL Failure

Perhaps the most significant issues brought to the front through IBL collapse are related to Sharīʿah principles and their applicability. For example, it is a well-known principle of *muḍārabah* that *muḍārib* will not be responsible for losses incurred if these losses are not due his negligence, dishonesty or misconduct. In one post IBL collapse lawsuit, one of the IBL directors was sued by an investor who had suffered loss.

The director had given guarantees regarding the financial position of IBL and he failed in his subsequent application to overturn the lower court decision given against him in favor of the investor. Even in the appeal case, the principle of sharing both losses and profit was upheld but not those due to negligence (Nathiel, 2010).

Another important Sharīʿah issue is related to the principle of *istiḥsān*, closely associated with and resembling the common law principle of equity. In contemporary Islamic finance, *muḍārabah* deposits are risky for its depositors but provide the bank with sustainability and high returns. However, the contractual relation between the bank and these deposit holders is such that they are mostly superseded by secured credit holders who are safe from any risk.

This happened IBL *muḍārabah* depositors when the claims of secured creditors were preferred over those of these depositors. *Muḍārabah* depositors were simply ranked parripassu with unsecured creditors. It is, no doubt, a challenge to the *istiḥsān* principle of Sharīʿah. According to Nathiel (2010), the situation was also objectionable at the assets side of

IBL. It is a general insolvency principle under Islamic law that once the debtor is declared bankrupt, the administrator should undertake the liquidation of his estate.

The debtor is not allowed to erode the value of the bankruptcy estate that might lead to decrease in the right of creditors. However, Qur'ān also directs believers to give relief to the debtor in distress. In this situation, if relief is given to the debtors of bankrupt debtor, it will affect the creditors negatively. In the case of IBL, it had R150.60 million receivables out of which R45.66 was considered as non-performing. It is not difficult to understand that if further relief, in the form of delay in debt payment or reduction in receivables, were given to debtors of IBL it would have harmed the IBL creditors more. Nathiel (2010) concludes that many debtors of IBL ironically availed such opportunity.

Sharīʿah concern was also found in the process of collecting debts which has specific ethical principles. Since IBL functioned in a secular jurisdiction, the issue was addressed from the perspective of secular law. Accordingly, the liquidator has discretion regarding many aspects of this problem. For instance, it can charge interest for late payment of receivables which is not in accordance with Sharīʿah. But an issue is raised regarding the collection of long term debt in the form of *murābaḥah* and *ijārah*. Due to the length of such loans, winding up process may take years to complete which is not efficient. Alternatively, there are two other options available: debt novation and sale of receivables to other Islamic banks. However, the problem with debt novation on a mass level is that it requires the agreement of all the three parties and the potential creditor may not get extra amount over the face value of receivables under Sharīʿah principles.

The sale of debt at discount is already contested and is generally prohibited except in Malaysia. In this situation, the debts of a bankrupt Islamic bank can be novated to other Islamic banks by the liquidator. Nevertheless, this will hardly be possible in regions where Islamic banking is not well developed.

1.6 Conclusion

Many lessons are embedded in the downfall of IBL that provide good insights for the Islamic financial institutions in general and Islamic banks in particular. On the one hand, IBL was involved in gross misconduct on both Sharīʿah and operational level, showing both the lack of and need for proper supervision of the Sharīʿah complaint entities. More precisely, if Sharīʿah audit had been in place, it would possibly have curbed the non-compliance activities.

On the other hand, when the bank went into trouble, the regulatory authorities were ill-prepared for the situation. This is where the issues of lender of last resort and deposit insurance are discussed by commentators in the context of IBL collapse. Another challenge is the sale of debt when an Islamic bank goes bankrupt; if an Islamic financial entity goes into liquidation in the future, how its long term debts will be treated? It is well known in Sharīʿah that the sale/transfer of debt is a critical issue. However, in the case of an Islamic financial institution going into liquidation, this issue has to be addressed with, perhaps, a new understanding of the present realities of finance world. All in all, it seems that the issue of insolvency and bankruptcy in the context of Islamic finance is not paid the attention that it deserves. While Islamic law sufficiently dealt with the insolvency of individuals, it is silent on the issue of corporate insolvency.

This is an area where Sharīʿahscholars need to step forward and, using the tool of *ijtihād*, derive the respective rulings of corporate bankruptcy that can help address future bankruptcies in the context of Islamic finance.

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