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## **To bail-in or bail-out? That is the question: Islamic Investment Banking Bonds**

### **Features**

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*This article offers a brief overview of the issues faced by sukuk investors and Islamic banks concerning Sharia compliance in light of the EU Bank Recovery and Resolution Directive. It does not analyse the various sukuk structures, but instead, provides an easy to follow overview to highlight the definition of Islamic bonds followed by the underlying defining principles to which regard must be had for the bonds to be ethical and compliant with Sharia.*

### **KEY POINTS**

- Islamic bank resolution must be considered in light of Sharia.
- Sharia compliance within sukuk is here to stay and not just to be certified at issuance.
- The application of BRRD in Islamic bank failure could render the sukuk non-Sharia compliant.

Islamic Investment Banks in the UK are, subject to the EU Bank Recovery and Resolution Directive (BRRD). Banks which have issued Islamic bonds (known as sukuk (plural) sakk (singular)), to finance projects may not have given due consideration to the impact of the BRRD.

Islamic investors with a desire to invest in an Islamic law (Sharia) compliant manner may come unstuck by virtue of the bail-in requirements imposed by the BRRD. It is necessary to understand the basic underlying principles governing Islamic bonds before consideration can be given to the question of compliance with the BRRD within the context of Islamic finance.

## DEFINITION AND DEFINING PRINCIPLES

A non-profit organisation known as The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has issued standards for 14 different sukuk structures. According to para 2 of p 307 of the Sharia Standards for Financial Institutions 2008, issued by the AAOIFI, sukuk are defined as being:

**"certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity."**

A key feature is the underlying religious yet remarkably socialistic aspects of Islamic bonds, all of which share the same underlying principles.

## DEFINING PRINCIPLES

There are four main defining principles for Islamic bonds. First, the transaction must not receive (nor pay) interest. Interest carries with it gains to the lender compared with an inherent injustice to the borrower, in circumstances where the borrower carries most, if not all, of the risk. In conventional bonds the borrower is liable for the principle plus interest. An integral aspect of Islamic finance is risk sharing, a feature often non-existent in conventional bonds. Interest is accordingly forbidden as it is considered "an excess".

The second principle is that transactions must avoid uncertainty. Every party to the transactions must know what to expect as this ensures an informed decision on the part of the investor.

The third principle is "gambling". For a transaction to be compliant with this principle it must not be based on acquiring wealth by chance or participating in a game of chance.

The fourth, perhaps most important principle is that Islamic financial instruments must not be used to fund prohibited products or industries considered detrimental to society. The prohibited industry categories include prostitution, pornography, alcohol, pork, tobacco and generally, products that are based on uncertainty. Many environmental and transport infrastructure projects therefore could well benefit from Islamic finance and green bonds because of the societal and green benefits.

## COMPLIANCE

Banking and financial institutions globally must ensure compliance with all applicable laws, rules and regulations. Since the global financial crisis of 2008, compliance has become an integral component to the integrity and reputation of an organisation. Islamic banks are no exception.

If anything, there are greater demands (and by implication greater costs per transaction) on Islamic banks and Islamic compliant transactions, in the wake of the global financial crisis of 2008.

## DUE DILIGENCE

Banks and financial institutions alike need to ensure compliance with the BRRD, irrespective of whether the financial instruments are Islamic or conventional bonds. Of equal significance is the need to carry out due diligence on the viability of the transaction, which by necessity, must be carried out at an early stage. On the assumption that compliance and due diligence are satisfactory, one must also consider the applicability of the BRRD to sukuk issuances.

In keeping with the underlying defining principles, the obligor/originator bank seeking capital, establishes, as agent under an agency contract ("*wakala*"), a Special Purpose Vehicle (SPV). The SPV issues sukuk to investors. The bank (as wakeel/agent of the SPV) invests the proceeds from the investors in Sharia compliant assets, in return for which the bank is entitled to charge a fee, and retains profits over a specified amount. This arrangement would seldom be called into question on being compliant, prior to the BRRD. However, the bail-in requirement of the BRRD perhaps provides a twist in the tale.

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## BAIL-OUT

Banks such as Northern Rock and Lloyds plc have in the global financial crisis been bailed out. Bail-out in essence is a capital injection of taxpayer funds from the Treasury. The twist of the BRRD is that as a matter of English and EU law, an Islamic bank with a UK base is subject to the "bail-in" provisions of the BRRD, as opposed to the previous position of a bail-out.

## BAIL-IN

The bail-in mechanism empowers the Bank of England (BoE as the relevant resolution authority) to intervene and write down the Islamic bank's liabilities converting funds from existing creditors to prevent failure. The BoE is able to exercise its power to "resolve" a bank that has failed or is likely to fail and is not reasonably likely to be able to recover and no other action will be taken to prevent the bank from failing. In practical terms a key objective of the BRRD is to prevent a "too big to fail" scenario. Accordingly the BoE's main resolution powers include the ability to:

- sell the bank;
- transfer performing and non-performing assets; and
- bail-in.

The point can be illustrated by application of the bail-in tool to the Lehman Brothers collapse in September 2008. Instead of the \$25bn of unrealised losses that by virtue of bankruptcy became approximately \$150bn, if Lehman had been subjected to a bail-in it could have continued to operate which would in turn have prevented a run on the bank.

If an Islamic bank were to fail in the UK now, the BoE would under the BRRD have the power to dictate recapitalisation terms. In this scenario, assets would be written down. Recapitalisation would consist of the conversion of existing holdings. Holders of unsecured debt would also be converted, in some circumstances by an agreed percentage and receive equity in the new Islamic bank.

Whilst some senior unsecured and secured creditors and customers would remain unaffected, some of the bank's previous shareholders would receive warrants that only have value in the event of a successful turnaround.

One cannot help but agree with the proposition that the rough justice dispensed by a regulator reorganisation is far too interventionist for the functioning of a free market.

One might be forgiven for thinking that there is too much power in the hands of the BoE. That said, when viewed from the perspective of insolvency, investors are likely to be better off than in the event of a default leading to liquidation. However, only time will tell whether the exercise of the power to resolve is used in a capricious and arbitrary manner. Whilst in theory the application of the BRRD into contracts seems like a great plan for conventional bond issuances, the position must also be considered for Islamic bond holders from the perspective of the underlying defining principles.

## **SUKUK AND BRRD: DEVIL IN THE DETAIL**

Islamic banks are not immune to crises. Banks with operations within the UK are certainly not immune from the imposition of the BRRD. In the unfortunate event that an Islamic Bank is subjected to the resolution regime, the position is not entirely clear as to the impact of resolution on sukuk. One might *prima facie* consider that, amounts held by the bank as agent under the SPV are unlikely to be affected.

*Prima facie*, that might be the correct approach, particularly where the funds are held on trust. The difficulty though, arises on a resolution triggering event which could potentially write down the liability of the bank to the sukuk holder and convert debt to equity, either in its entirety or in part.

The ability to be able to write down the sukuk could itself be called into question by the uncertainty principle, because it is difficult to gauge the extent to which the sukuk might be subjected to a write down. Perhaps an unforeseen side-effect of the BRRD. An additional unintended consequence may be that the proceeds from the once Sharia compliant investment potentially become the fruits of the non-compliant transaction, thereby falling outside the scope of permissible income.

## **ISLAMIC GREEN ETHICAL SUKUK (IGES): WHAT NEXT?**

Investors would need to know the compliance status of the proposed sukuk with Sharia as well as the BRRD. Investors should be expected to seek independent advice given the lack of a standardised view of Sharia compliance. Sukuk issuance in the meantime is likely to become a negotiation process. What next for Islamic green and ethical bonds is a question of perceived compliance with Sharia not least by virtue of diverse opinion on compliance.

Whilst it can become a question of cost and benefit ratios, another possible future for sukuk could be that issuers do the unthinkable and seek the opinion of the BoE as regulator and resolution authority, to potentially minimise the risk of uncertainty and increase investor confidence.

In the words of Shakespeare:

**To be, or not to be, that is the question:**

**Whether 'tis Nobler in the mind to suffer**

**The Slings and Arrows of outrageous Fortune,**

**Or to take Arms against a Sea of troubles,**

**And by opposing end them: to die, to sleep**

**No more**

One thing is certain. There is substantial investor appetite for Islamic green bonds and ethical investment opportunities within infrastructure projects. Advisors will, therefore need to ensure compliance with Sharia and the bail-in and bail-out powers of the BoE.

\* \* \* \* \*

***Further Reading:***

- Recent trends and new perspectives in global Islamic fixed income capital markets [2014] 11 JIBFL 713.
  
- The application of Islamic finance principles under English and DIFC law [2014] 9 JIBFL 573.
  
- LexisNexis Loan Ranger blog: Sukuk reaches western markets.

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