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Insolvency Risks in Islamic Banks: Lessons from Comparative Case Studies of Failed Institutions

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Abstract

This study investigates the causes of insolvency in Islamic banks (IBs) through a qualitative multiple-case analysis of failed Islamic financial institutions (IFIs) in Turkey, Jordan, and South Africa. The selected cases İhlas Finans (IF), Islamic Bank Limited (IBL), Islamic Investment House (IIH), and Islamic National Bank (INB) are examined to identify key governance, regulatory, and Shariah-related weaknesses that contributed to their collapse. Data were collected from secondary sources, including regulatory reports, court records, and academic studies, and analyzed using thematic and comparative approaches. The findings reveal that inadequate governance, absence of comprehensive insolvency and recovery frameworks, and weak Shariah governance were central causes of institutional failure. Conflicts between national laws and Shariah principles further compounded the insolvency risks. The study contributes to the literature by providing a cross-jurisdictional understanding of insolvency risks in Islamic banking and proposing the need for structured resolution mechanisms aligned with Shariah principles. Policy recommendations are offered to enhance regulatory supervision, strengthen Shariah governance, and improve crisis preparedness within the Islamic banking sector.

Keywords: Islamic banking, insolvency, financial institutions, governance, risk management.

Introduction

Islamic banks are often deemed resilient and stable as opposed to counterparts of conventional banks due to unique Shariah principles and rules applied in the operation and functions of the banks. However, the recent insolvency cases worldwide have cast doubt on this perception. Notwithstanding the emerging developments of Islamic finance with a total asset of USD 4.9 trillion (with US$ 3.6 trillion of Islamic banking assets) in 2023 (London Stock Exchange Group (LSEG), & Islamic Corporation for the Development of the Private Sector (ICD), 2024), the

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collapse of Islamic financial institutions such as Ihlaas Finans (IF) from Turkey, Islamic Investment House (IIH) and Islamic National Bank (INB) from Jordan, as well as Islamic Bank Ltd (IBL) from South Africa, reveals significant vulnerabilities and unattended issues within the Islamic banking sector.

Thus, identifying the principal risks and structural weaknesses of Islamic banks through evaluation of the existing insolvency cases would help to develop a holistic understanding of the legal, regulatory, and operational aspects of Islamic banking insolvency. An evaluation of these cases would also offer the flexibility of an in-depth examination of relevant factors in the problem, which will lead to helpful, sound, and non-specific conclusions that would be helpful in the future of Islamic banks in mitigating several risks and factors. Additionally, the evaluation and complication of these case studies would provide considerable lessons to strengthen Islamic banks against the risk of insolvency in terms of regulatory changes, corporate governance, and banking compliance. With a focus on the structural weaknesses and governance of these cases, it would also help to develop additional control mechanisms unique to Islamic banks in order to maintain the prudence and stability of Islamic banks while maintaining their Shariah principles.

This study adopts a qualitative multiple-case study approach aiming to explore the causes of Islamic banking insolvency by revealing gaps in the industry and highlighting the need for robust frameworks to mitigate such risks. Case selection was based on the availability of documented insolvency cases across different jurisdictions (Turkey, Jordan, and South Africa). Data were collected from secondary sources including regulatory reports, academic publications, and institutional records. Thematic and comparative analyses were employed to identify patterns and lessons across cases. It is anticipated that the outcome of this paper would contribute to the broader discourse on Islamic finance, offering insights into how Islamic banks can strengthen their operational resilience and avoid the hitches that have led to the downfall of their predecessors.

Causes of Insolvency in Islamic financial Institutions

The insolvency of Islamic banks is determined by observing the financial position where the bank's liabilities of debts exceed their assets. A consequence of insolvency includes bank runs, where a large number of depositors withdraw their money from the banks at the same time, which are also a result of failure to meet Shariah compliance as well as illiquidity issues within the bank. The major causes of Islamic bank failures can broadly be categorized into three areas: 1. inadequate governance and oversight, 2. lack of formulated insolvency processes, and 3. absence of Shariah governance framework (SGF).

Firstly, governance is critical for Islamic banks, which need well-functioning internal and external controls to protect the unique requirements of Islamic banks in addition to the requirements for a regulated bank. Muneeza and Hassan (2011) argue for the need for sophisticated Shariah Governance Codes to steer not only advisory boards but also those undertaking specialist roles like that of the Shariah Committee (SC) or Shariah Supervisory Board (SSB) having to perform distinct functions. Regulatory Supervisory Authorities (RSA) of a country also provide external supervision and augment the governance structure. The absence of effective governance and oversight was one of the key reasons for the failure of the aforementioned insolvent cases around the world.

Furthermore, the insufficiently developed insolvency processes fail to aid the recovery of financially troubled Islamic banks (IBs), often resulting in their liquidation. Existence of an appropriate insolvency perspective supported by pertinent institutions eases the controlled winding-up or liquidation of distressed Islamic Banks. This was the case with Tabung Haji (TH) in Malaysia which recovered from technical insolvency with the help of a restructuring and rehabilitation plan that involved sukuk issuance and asset transfers to an SPV (Tabung Haji, 2021).

Thirdly, the lack of an appropriate SGF remains as one of the greatest weaknesses of Islamic Banks. The absence of such a framework in IF, IBL, IIH, and INB led to violations of Shariah principles like granting undue early withdrawals to mudārabah depositors or ribā for delayed payments. An international SAC or ISAC as proposed by Hashim and Issacs (2016) could set a global SGF (GSGF), although international acceptance is a challenge. They argue countries must first create national SACs (NSAC) and SGFs (NSGF) to lay the groundwork for international collaboration.

Case Studies

The case studies that are presented in this paper are Ihlas Finans (IF) of Turkey, Islamic Investment House (IIH) and Islamic National Bank (INB) of Jordan and Islamic Bank Ltd (IBL) of South Africa. They are chosen mainly due to the availability of literatures concerning them albeit scarce. Nevertheless, it is sufficed to build a case study on each of them. Followings are the case studies on the said insolvent Islamic Banks.

Ihlas Finans, Turkey

Ihlas Finans (IF) was established in 1995 as a Special Finance House (SFH) under Decree No. 94/6193 of the Council of Ministers, designed to offer interest-free financial services in compliance with Islamic principles (Abdullah et al., 2016).

Unlike conventional banks, SFHs such as IF faced significant regulatory constraints. They were not covered by deposit insurance provided by the Central Bank and were prohibited from investing in government securities, which significantly limited their liquidity management options (Yanikkaya & Pabuccu, 2017).

IF encountered severe operational challenges stemming from both internal mismanagement and regulatory limitations. The bank's governance was notably deficient, with a board of directors comprising individuals lacking relevant banking experience. Some members were financed by IF or had connections to previously failed banks, which led to conflicts of interest and poor oversight (Askari et al., 2009).

In addition, there is a more serious form of mismanagement, such as using fictitious contracts for solving liquidity difficulties and capitalizing above the allowed limits, which, together with other violations of prudential regulations, put the bank in an even worse state of financial health (Ali, 2007).

The Ihlas Finance (IF) was poorly affected by the financial crisis of the early 2000s, resulting in a liquidity crisis for the organization. While a general Turkish bank run was taking place, desperate IF depositors were precipitated by the concerns of loan safety. Although the Mudharabah account permits withdrawals after a certain period of time, depositors withdrew over $200 million, provided that the withdrawal windows for the accounts were fixed at terms, which allowed only extraordinary, and with immediately accessible entry (Ali, 2007). Before providing any liquidity intervention or other resolution aid, the Banking Regulation and Supervision Agency (BRSA) decided to revoke IF's banking license on February 10th, 2001. The other board decisions were taken due to substantial breaches of laws such as uncovered connected lending, failure of honor on public debts, and unhealthy captive subsidiaries investments (Askari et al., 2009).

Ihlas Finans was on the brink which highlighted the lack of regulatory attention given to Islamic financial institutions in Turkey. The BLRA’s default technique of stripping IF’s license, instead attempting to devise a more lateral resolution approach such as liquidity provisions or rapid brushing away of assets, caused extraordinary damage to depositors and wage-earning creditors during the liquidation process (Nathie, 2010). The absence of a Shariah governance framework or specific Shariah advisory body meant that IF unequipped with crucial steering served guidance that contributed to their demise (Yanikkaya et al., 2017).

The collapse of Ihlas Finans has triggered a chain reaction on the public’s perception of and confidence in participation banking in Turkey. It has deepened the trust gap towards Islamic finance institutions and accentuated the demand for SFHs to be treated within the regulatory context crafted for their particular problems and circumstances (Artar et al., 2016).

This case is an international warning on the consequences of weak governance: absence of adequate deposit insurance, lack of regulatory control, and absence of good management may lead to a failure of an institution's stability. The case has underscored the regulatory gaps which take into account the specific nature of Islamic finance as well as the need for structure that not only governs but helps rebuild these institutions to avert such collapses in the future.

Islamic Bank Limited, South Africa

Islamic Bank Limited (IBL) is the first Islamic bank in South Africa and is a successor of Islamic Corporation Limited (ICL) which was established in 1981. ICL metamorphosed to IBL in 1988 after its eleventh unsuccessful attempt to secure a banking license from the South African Reserve Bank (SARB) (Taliep et al., 2010). Designed to address the financial servicing requirements of the Muslims in South Africa, IBL confronted legal and regulatory obstacles right from the beginning.

Islamic banking institutions such as IBL struggled to integrate with the secular legal system of South Africa's region. Initially, South African law was not particularly welcoming towards Islamic finance, which posed difficulties for IBL due to the Shariah compliant constraints of law IBL was bound to. Regardless, IBL managed to sustain their operations (within the constraints imposed) due to abundant community support.

However, the bank's success was short-lived. By 1997, the SARB announced the winding up of IBL due to severe mismanagement issues including fraud, unsecured lending, insider loans, and breaches of Shariah governance (Nathie, 2010). The problems were compounded by poor corporate governance and inadequate risk management. Examples of mismanagement included fictitious accounting practices and failure to address non-performing assets, which led to IBL's ultimate collapse (Rahman & Zada, 2016).

South Africa's national law often took precedence over Shariah principles. For instance, the case of Intramed (Pty) Ltd (in liquidation) v Standard Bank of South Africa Ltd [2008 (2) SA 466 (SCA)] allowed interest on delayed debt despite Shariah prohibition against ribā (interest). Conversely, in Carrim v Omar [2001 (4) SA 691 (W)], the court upheld the Shariah principle that a mudārib (investment manager) is responsible for losses due to negligence.

The South African regulatory framework for Islamic banks did not provide specific guidelines or protections. The SARB, which regulated both conventional and Islamic banks, struggled to accommodate the unique operational and contractual aspects of Islamic finance (Taliep et al., 2010). The absence of a national Shariah Governance Framework (SGF) meant that Shariah compliance was managed by internal Shariah Supervisory Boards (SSBs), which were not always effective in enforcing adherence to Shariah principles within the bank.

IBL was fraught with Shariah governance problems, including profit-sharing out of capital instead of earned income and ribā transactions. The management did not follow Shariah guidance and disregarded SSB warnings, which led to the collapse of the bank.

The SARB did not act immediately when IBL's financial problems became apparent. There was a lax approach to the management of the bank's liquidity crisis which was a major problem due to a range of mismanagement issues, resulting in enormous losses for depositors. Rather, the SARB opted to liquidate IBL instead of trying to resolve or rehabilitate them citing numerous Shariah and legal compliance breaches (Taliep et al., 2010).

Liquidating the Islamic Bank Limited (IBL) posed unique problems for the rest of the Mudārabah depositors and their ranking as claimants. In the declaration of insolvency, Mudārabah depositors were deemed to be subordinate creditors. This labeling was problematic due to the fact that it was a violation of the Shariah spirit of their investment. It's the nature of Mudārabah contracts, which differ from conventional debt instruments, that places depositors in a unique position which isn't fully appreciated within the general insolvency system. Because of this, there was a lot of anger from depositors who argued that their Shariah compliant investments were discriminated against vis-a-vis other creditors.

Among the various problems that arose in the liquidation process was overseeing contracts such as murābahah and ijārah. These contracts are associated with certain types of arrangements and obligations spanning multiple years and finances. There was a dispute regarding whether these contracts should live on during the liquidation phase. There were difficulties with how a liquidator was to take care of these active contracts and their predicts long-term obligations. The issue arose whether the contracts should operate as usual, suspended, or liquidated, and how these obligations would be reconciled within the mandates of the liquidation process.

Moreover, the liquidator's decision to sell receivables and the introduction of the interest on delayed payment further worsened the issues with liquidation. Discounted sale of receivables raised Shariah issues and so does the practice of selling them, as it may contain elements of ribā (interest), which is haram in Islamic finance. This posed an issue between the Shariah principles and the laws of South Africa. The Shariah frameworks, which, as noted in the preceding analysis, struggles to reconcile with a secular legal system's endorsement of delayed payment interest, brings additional complication to IBL's insolvency resolution.

The absence of particular rules on Islamic banks within the South African regulatory ecosystem was a factor for IBL's problems. Contributing factors to IBL's collapse were the SARB's policy of not stepping in early enough, an inappropriate intervention strategy for Islamic banks, and the absence of ex post resolution frameworks for Islamic banks. In addition, the capture debate regarding the permissibility of deposit insurance under Islamic finance added a layer to the problem.

The IBL case highlights the risk of not having a complete and integrated system design to regulate Islamic banks, one that accounts for Shariah governance and supervision. The case demonstrates the difficulties in imposing a secular legal system onto Islamic finance and emphasizes a gap in regulatory response for Islamic banking features.

The Islamic Investment House (IIH) and Islamic National Bank (INB), Jordan

Founded in Jordan on October 9, 1981, The Islamic Investment House (IIH) began with an initial capital estimated at 4 million Jordanian dinars (JOD), or USD10.02 million at the time (Saleh & Zeitun, 2006). The institution intended to function within the framework of the principles of Islamic finance such as mudārabah, murābahah, and istisna' with the intention of avoiding ribā (interest). The policy change mentioned above came as a direct response to the decline in profitability alongside escalated operational losses (Salameh, 2014). This mandated the central bank taking complete charge of the bank. An ad hoc executive steering group was formed to control IIH, but it was unable to stop the mounting aggressive torrents of lion-like cost overruns.

In 1988, the CBJ resolved to relocate IIH's assets and liabilities to a newly created Islamic National Bank (INB), which was formed as part of the cleansing process (Salameh, 2014). Set up by the Economic Security Commission (ESC) in 1985, INB was initially capitalized at 6 million Jordanian Dinar, with subsequent hikes to 7 million. However, the new bank was already facing some immediate burdens like the backlash by IIH depositors and shareholders (Saleh & Zeitun, 2006).

While designed to function as a bridge bank, operational and financial viability were elusive for INB. By April of 1990, INB's activities had been suspended, leaving it vulnerable to liquidation in default because of ongoing conflicts with depositors and shareholders (Salameh, 2014). An interim management committee was set up to try and restore order at IIH, but these efforts were not adequate to stem the rising tide of financial losses.

In 1988 the CBJ transferred the IIH assets to the newly created Islamic National Bank (INB) as part of a resolution process (Salameh, 2014). INB, established in 1985 by the Economic Security Commission (ESC), had an initial capitalization of JOD 6 million and increased later to JOD 7 million. The new bank, however, faced immediate challenges. Objections from IIH depositors and shareholders (Saleh & Zeitun, 2006) were only the beginning. While INB was designed as a bridge bank, on operational and financial grounds it struggled. As of April 1990, INB’s activities were on freeze which ultimately led to its liquidation due to continued conflict with depositors and shareholders (Salameh, 2014). ESC undertook liquidation procedures which were to cancel IIH stockholders’ equity and give priority to reimburse loans granted by CBJ (Salameh, 2014).

Both of the cases, IIH and INB, provide crucial understanding into the management of Islamic banking, their financial governance, and oversight policies. Each institution's liquidity crises revealed inefficiencies within their financial management, crisis management practices, and lack of a specific regulatory framework for Islamic banks. The absence of relevant Shariah control systems and insolvency frameworks during IIH’s and INB’s operations reveals the need for a robust legal and regulatory framework tailored to Islamic finance (Grassa, 2013). The failure of both of these Islamic banks illustrates how Islamic financial institutions lack comprehensive insolvency policies that ensure adequate protection for depositors.

Lessons from the Case Studies

There are a limited number of lessons to be extracted from the failure of the insolvent Islamic financial institutions cases as discussed in 3.0. The following are lessons from the case studies.

Strengthening the Bank Insolvency Regime

One of the key lessons to be determined from the case studies is the developed insolvency regime. It is apparent that the lack of a sophisticated bank insolvency system would place RSA and its financially distressed banks into dire straits with respect to illiquidity, bank runs, or legal breaches.

The Islamic regime was still in its infancy during the period under review. Regulatory and Supervisory Authorities (RSA) lacked effectively systematic frameworks in place for Turkey, South Africa and Jordan, which exist but are not really robust. The regime during the case study period was predominantly reactive, responding only in scenarios where institutions faced legal and operational liquidity crises, Shariah non-compliance, or rampant non-compliance. Despite having ALIP, there were no meaningful resolution mechanisms such as 'bail-out', 'bail-in', debt transfer, or bridge bank. Their JLIP did not see the light of day. So, the only alternative they had was to revoke the banking license, as in IF and IBL, or deregister them, as in IIH and INB, which effectively shuttered the banks permanently. It is clear from the evidence that withdrawing a license was the predominant approach to lean on further suggesting there were scant choices aside to dismantle the banks. The inadequacy of these measures tailors an unmistakable picture where loophole-laden negligence underscores bank insolvency regimes emerged as a foremost concern.

This is evident with IF and IBL, for which the RSA seemed to act rather decisively in withdrawing the banks' licenses after an extended period of contemplation. However, with IIH, the RSA is reported to have undertaken much more substantial resolutions before discontinuing operations. It was transferred to another bridge bank, INB.

In the absence of a proper insolvency framework, the Regulatory and Supervisory Authorities (RSA) would be responsive rather than proactive regarding risks and issues that arise. A good insolvency framework would involve effective and proper Recovery and Resolution Planning (RRP) that is prepared before the banks face distress.

Improving the Recovery and Resolution Planning (RRP)

An appropriate RRP is necessary to adequately equip the Islamic banks with the expectation of a potential financial crisis or insolvency (PWC, 2009). RRP is done by RSA or RA of respective countries and is issued to the Islamic banks for further action. In terms of RRP, it is the responsibility of Islamic banks to periodically submit their RRP to the RSA for further actions. PWC (2009) has identified the objectives of recovery planning which include: identifying and defining core businesses, triggers, and also defining options which could mitigate risks of failure and assessing credibility and viability of recovery efforts. For resolution planning objectives, these are forcible restructuring or efficient resolution (by regulator), identifying systemic/critical market functions, significant legal entities, and fundamental key processes along with dependencies and sustaining continuity of systemically vital functions/activities.

As it was the case with the failed banks above, they all had lack of foresight regarding RRP. This only points out to inadequate planning in advancing customized solutions to the possibility of financial crises or insolvency. Thus, these banks were not equipped to rehabilitate the banks when the financial crises hit.

The Need for Strong Governance and Supervisory

Islamic Banks require both internal governance and external supervision. Internally, it requires a corporate and Shariah governance system, while externally; it requires RSA governance. They must function collaboratively but independently exercise their authority. As per Mebid et al. (2024), corporate governance mechanisms have a positive role in reducing insolvency risk, which essentially has a negative relationship towards each other. Certain banks lack the respect to each other power or having an impassive attitude towards governance and supervisory that resulting in poor governance and supervisory functions.

For example, the above-mentioned banks may have some form of governance in place, but it is rather unstructured. As for IF, although its operations were pushed through with whatever Shariah law requirements were available such as ribā, profit-loss sharing, and nominate contracts including mudārabah, ijārah, murābah, and even murābahah, it lacks Shari'ah governance. Its Shari'ah governance was subsumed under general corporate governance. Therefore, when IF permitted depositors to withdraw funds during the crisis, he also permitted mudārabah investment depositors to withdraw, which contravened the terms of the mudārabah. This fits what Azmat and Subhan (2021) referred to as 'Epsilon States.' This is where the Islamic banks attempts to abide by deontological rules but lacks a commitment to ethical values render the impact negligible. It is a situation where the IB wants to hold with deontological rules but due to weak ethical commitment their impact remains insignificant. For example, in the case of IF, although they attempt to comply with Sharī'ah principles, their weak ethical commitment allows the mudārabah investment depositor to withdraw funds like an ordinary depositor.

Kleinwort Benson's Islamic unit trust fund suffered from lack of effective Shariah governance which, according to Hasan (2012), is one of the primary reasons for its failure. Kleinwort Benson was the first investment bank to offer an Islamic unit trust in the UK. Although they had financial acumen in commodities trading and capital markets, as well as a working knowledge of the London Metal Exchange, they did not have a Shariah advisory committee to supervise the funds. This lack of supervision undermined their Islamic fund. Consequently, the fund failed to gain confidence among prospective investors. With regard to IBL, the SSB has cautioned the management to correct the Shariah breaches concerning the ribā loan advanced, capital profit without operational income, and in which the capital provider's losses were not mitigated by the capital provider.

The management, however, did not do anything to fix it. Not doing anything could later cause a Sharīah breach and non-compliance legal issues, and that risk is better avoided. Something similar happened in The Investment Dar Company KSCC v Blom Development Banks Sal [2009] EWHC 3545 (Ch).

Briefly, The Investment Dar Company KSCC ('Appellant') and Blom Development Banks Sal ('Respondent') entered into a wakālah-based deposit contract where the former was to pay the latter the principal plus profit of USD10 million. While the Respondent expects payment, the Appellant asserts that the purported deposit is not Shariah compliant, thus the contract is null and void. The Respondent counters that the agreement in question has Shariah committee endorsement. The court observes that it is apparent from the evidence put before it that the relationship is a contract to pay interest disguised as a bet. Even so, the court did not declare the contract a nullity. Instead, the court orders that it be tried.

However, this case serves a lesson that Shariah committee needs to be vigilant in their responsibility in order to prevent the financial product from becoming invalid. With respect to IBL case, their SSB has appropriately attempted to manage the potential risk and complications that IBL may face in the long run. IBL management, however, chose to ignore the dismaying guidance proffered by SSB. As a result, IBL is now subject to the winding up order from SARB.

As for IIH & INB, the lack of adequate controls within their corporate governance framework resulted in brazen theft and fraud. There was minimal intervention from internal corporate governance structures until external bodies such as CBJ and ESC got involved. These instances also depict instances where management may bypass Shariah prerequisites or rulings put forth by Shariah advisory council.

In the same vein, five IFIs: Faisal Islamic Bank of Egypt, Kuwait Finance House, Tadamon Islamic Bank, Qatar Islamic Bank, and Dubai Islamic Bank, because of poor oversight on Shariah governance and absence of screening process, resulted in their assumption that they have allocated into a Shariah compliant commodity portfolio purportedly offered by the Bank of Credit and Commerce International (BCCI). Later it has been discovered that "there is no evidence to suggest that the bank actually entered into any commodity contracts" (Grais & Pellegrini, 2006).

Conflict of Laws

When the national law does not align with the Shariah requirement conflict of laws occurs. In this case, the national law will always prevail. It needs a law harmonisation framework to overcome such issues (Shukri 2020) or a less restrictive approach with regard to government interference on matters of Shari'ah.

While the national laws governing the banks under study are conventional, the practices of the Islamic Bank (IB) are based on Shariah law. For the case study, the Islamic banks were also governed by conventional law in Turkey, South Africa, and Jordan. The national law takes precedence in cases of conflict. There was no special provision or codified law that permitted the application of Shariah principles in Islamic banks. It relied merely on overarching general principles of Sharīʻah, which can easily be disregarded if there is no basis in codified law. This was the case for IF with regard to the allowing withdrawals by mudārabah investment depositors and imposing ribā on delayed payments in IBL.

Poor Hiring Process

The Bank has a lack of professionalism due to indirect involvement of third parties. That includes from the selective hiring an appointee to questionable business relationships and political interference. Ultimately will erode the liquidity of the Islamic banks and lead to financial difficulties or insolvency. In the case of IF, its BOD was filled with appointees from a failing bank. In the absence of external influence, this kind of appointment would have not taken place. Furthermore, some of the appointees had no relevant qualifications and work experience in banking or corporate.

In IBL, nepotism has already compromised its corporate governance when substantial and unrecoverable financial advances were made to acquaintances and other "friends". In the instance of INB, however, the refusal by Queen Alia Fund and the Orphans Funds to actually pay for the value of their equity stocks as they had pledged has led to the collapse of INB before it had even begun operations. A refusal so great could not happen without a considerable amount of political meddling.

Analysis

The case studies discussed in this paper have determined that poor governance is the primary factor for Islamic banks' insolvency. The weak governance is usually due to different forms of mismanagement, particularly in financial management, business ethics, corporate governance, nepotism and cronies, management versus Shariah advisory conflicts, and so forth. To a certain level, it becomes a civil legal dispute and a criminal legal dispute, such as fraud. While mismanagement is an internal factor, lenient supervision by the respective RSAs, lack of government support, and politically motivated external factors. Ultimately, these internal and external factors create the perfect combination to cause liquidity issues, which lead to insolvency and liquidation.

It has also been noted that the banks, which are the subject of the case study, do not seem to have any prior preparations for bank insolvency. Moreover, there is no such thing as a specific or dedicated insolvency law for banks. As illustrated in the case study, their banking insolvency system appears to have utilized the corporate insolvency framework instead.

The Shariah consideration is rather focused on the products-related issues rather than more critical matters pertaining to insolvency, such as a bailout, deposit insurance, asset-liability transfer, debt selling, and creditor's ranking. For instance, as it relates to IBL, its SSB has disagreed with debt sale at a discount, which in South African law was permissible. Also, SSB disagreed with the interest payment on the IBL debtors on account of payment delays, but that was permitted by their legislation.

As a consequence, these Islamic Banks were not supported with a Shariah ruling on bankruptcy issues when insolvency and bankruptcy set in. Instead, the rulings were made during the actual scenario rather than crafted out of appropriate deliberation and research prior to declaring insolvency. As a result, it is accepted less willingly by the management who were unacquainted with such rulings. In the case of Ihlas Finans (IF) where the Banking Regulation and Supervision Agency (BRSA) does not permit the deposit insurance on grounds that an Islamic deposit insurance mechanism was non-existent is illustrative of this.

Due to these circumstances, although the mudārabah investment account is on the liability side when the IF was close to insolvency, the IF management let its holders withdraw their investment so that the losses could be minimised. In mudārabah, it is true that the rabbul mal is liable to bear the losses, but he must also be given the opportunity to mitigate those losses, for example, through deposit insurance or third-party guarantees. However, at that time, there was no mechanism in place to provide deposit insurance. This placed IF in a dilemma regarding the absence of infrastructure to accommodate Sharī`ah principles that require proper implementation. IIH and INB were in this state of dilemma without having a Shariah board or Shariah governance framework. Moreover, their insolvency legislation for Islamic banking was not yet established. Still, the Board of Directors of IF was in this troubling situation bound by Shariah constructs that require profound deliberation to general Shariah principles.

The critical lessons concerning both internal and external governance, as examined in the case study, shed light on why the Islamic banks under study became insolvent in the absence of proper SGF at the national level. The Shariah subordinate stipulations regarding insolvency were mostly in the discussions at the infancy stage. The Shariah board ruling on the mudārabah account having no riba was astonishingly ignored by the BOD due to a power conflict. It is clear that the best Shariah rulings concerning insolvency will not be enforceable without governance. Regardless, this Shariah non-compliance notice may worsen the bankruptcy cost and diminish the recovery rate of Islamic Banks in comparison to CBs.

At some point, prior to the post-insolvency stage, the charges within Shariah pertaining to insolvency need to be anticipated, deliberated, and sanctioned by the Shariah board ideally not during or after the fact. FSB (2020) also recommended a wider pre-consultation on the sharp insolvency framework, which is aligned with this suggestion. The interface of BOD, Shariah board, and RSA needs special attention when aligned with conventional national legislation. The takeaway is that the Shariah governance policies and frameworks on the issues of bank insolvency should not be approached in an ad-hoc manner but planned and put in place prior to the actual insolvency event.

Table 1: *Key Issues Faced by IFIs During Financial Crises*

Aspect	IF	IBL	IIH	INB	Analysis
Governance Issues	Weak governance; poor Shari'ah compliance.	Weak governance; ignored Shari'ah board's warnings.	Weak governance; embezzlement and fraud.	Weak governance; political interference.	Governance failures led to mismanagement and inability to address financial distress effectively.
Insolvency Regime	Rudimentary; reactive; lacked systematic tools.	Rudimentary; ad-hoc resolution; limited tools.	Some resolution tools applied; transition to bridge bank.	Ad-hoc resolution; liquidation process.	Insolvency frameworks were underdeveloped and reactive, failing to provide proactive solutions.
Recovery and Resolution	Absent; lacked preparation for crisis.	Absent; inadequate planning.	Partial; involved bridge bank but lacked	Absent; limited resolution efforts.	Absence of comprehensive RRP led to poor crisis management

Planning (RRP)			comprehensive RRP.		and exacerbated financial instability.
Legal and Shari'ah Conflicts	National law overruled Shari'ah principles.	National law conflicted with Shari'ah; no systematic application.	National law conflicted; partial Shari'ah compliance.	National law conflicted; weak Shari'ah framework.	Conflicts between national laws and Shari'ah principles left institutions without clear insolvency guidance.
Resolution Tools	None; license revoked.	Limited; depositor's coverage, but ad-hoc.	Bail-out, bridge bank; some tools applied.	Write-off, depositor's coverage; administrative-led resolution.	Inadequate resolution tools and lack of systematic approach led to ineffective crisis management.
Intervention Actions	Administrative; license canceled.	Administrative; license canceled.	Administrative; bank activities frozen, then liquidation.	Administrative; management board dissolved, then liquidation.	Intervention actions were primarily administrative, lacking judicial oversight and systematic approach.
Lessons Learned	Need for proactive insolvency regime and RRP.	Importance of robust governance and Shari'ah compliance.	Necessity of comprehensive insolvency tools and frameworks.	Integration of Shari'ah principles in legal frameworks is crucial.	Strong internal governance, effective RRP, and alignment of national laws with Shari'ah are critical for preventing and

		managing insolvency.

Source: Author

Table 1 reveals critical shortcomings in how RSAs manage liquidity and insolvency issues in Islamic Banks. The data indicates that IFs and IBLs struggled significantly due to inadequate resolution and liquidation tools.

Specifically, IFs have not applied effective resolution or liquidation mechanisms to address insolvency issues. In the case of IBLs, depositor coverage was introduced, but it was more of a reactive measure rather than a proactive, systematic approach to prevent large-scale bank runs. For example, although IIH was ultimately liquidated, considerable efforts were made by RSAs to handle the situation proactively. This included implementing a resolution process involving bailouts and transferring assets and obligations to a bridge bank. In contrast, the INB did not undergo a resolution process but was directly liquidated. Some methods such as equity write-offs and depositor coverage were applied during complete liquidation, but the approach taken was mostly administrative rather than judicial.

Fundamentally, the examination reinforces that a lack of effective internal governance in tandem with weak external oversight by RSAs can result in misgovernance, fraud, liquidity crises, and, ultimately, bankruptcy. Conversely, inadequate governance risk is mitigated by strong internal governance together with active supervision by RSAs, leading to the early detection and prevention of potential red flags, thus minimizing the chances of becoming insolvent. Grove and Victoravich (2012) also support these findings, noting that internal control and external supervision are essential for remaining financially stable.

Conclusion

The shortcomings of the IFIs underscore a glaring gap in banking management with respect to governance, supervision, and planning for financial crises. It also indicates that the practice of poor governance and inadequate supervisory systems by the management of the banks, in addition to the liquidity and insolvency risk of the institutions, was left unattended. Nonetheless, the risk of insolvency is not unique to Islamic banks there are sufficient evidence suggestion that conventional banks facing similar challenges for instance, collapse of well-known Lehman Brothers, Bear Starnes, Northern Rock, and Merrill Lynch Dow were also due to governance failures and poor oversight (Caprio, 2013; Grove & Victoravich, 2012; Kirkpatrick, 2009).

Several studies on Northern Rock and Lehman Brothers also found that banks did not have adequate tools and regimes for managing insolvency and liquidation (Fleming and Sarkar, 2014; Cunliffe, 2017; Blei, 2008; Vivian, 2011). Failure of these large and globally recognized institutions reveals that the issues faced by the Islamic banks are not unique, however, challenges that affect the banking sector at large. The root cause of these issues is primarily due to the absence of preparedness and coordination for financial crises and inadequate resolution mechanisms with the bank's management. Similar to the requirement for its compliance with regulations for conventional banks, Islamic banking does not differ due to the additional requirement to follow Islamic principles since non-compliance with rules by either type of bank would lead to reputational risk and could lead to the bank's failure, such as through a bank run.

The case studies highlighted the collapse of IIH and INB, which are mainly due to governance failures and lack of supervisory roles, which are again not limited to Islamic banks. It explains that any banking institution, regardless of its type or size, is likely or can be exposed to the risk of failure with the presence of a weak governance system and inefficient regulatory supervision. In order to address these systemic issues that could lead to whole banking institutions' failure, the governance system, supervisory frameworks, and a robust crisis management tool shall be developed and applicable to all banking sectors.

Firstly, for enhanced governance for the banks, it includes the implementation of strong internal control functions and nurturing a culture of transparency so that the primary internal stakeholders, such as the board of directors and executives, are accountable for their decisions and actions. Such good governance practices shall also be aligned with the evolving regulatory standards unique to Islamic banks and to general banking requirements.

Secondly, strengthening the supervisory frameworks for effective monitoring and risk management shall be enhanced to a level that is capable of detecting early warning signs of financial distress and ensures that management has sufficient time to take corrective actions to any potential risk or hazard. Therefore, collaborative efforts between regulatory authorities and financial institutions are crucial to share insights and improve crisis management strategies to maintain a robust banking sector.

Thirdly, there is a need to formulate and sustain elaborate plans for dealing with crises, which are forward-looking resolution plans. Such plans should have clear outlines on how to deal with lack of liquidity and financial distress, along with continuity of operations. In addition, there is a need to simulate, stress test, and refine the plans to enhance their practicability and achievable objectives.

Lastly, a collective focus on understanding how to manage unique risks and understanding finances is crucial for bank managers and employees in risk evaluation departments. The financial systems of the banks also shall be compatible and change along with the dynamic systems in safeguarding the banks from future financial recessions and other external challenges that may arise. It would also help the banks to maintain their reputation in the long run and at the same time strengthen the overall economy through their intermediary role for finances and other services, which complies with the rules and principles of Islamic law.

This study is limited by reliance on secondary data and a small number of case studies. Future research could incorporate primary data collection, including interviews with regulators and practitioners, or comparative quantitative analysis of insolvency indicators between Islamic and conventional banks.

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