Rasheed Mohammed Al Maraj: Challenges facing Islamic financial institutions

Speech by His Excellency Rasheed Mohammed Al Maraj, Governor of the Central Bank of Bahrain, at the 14th Annual World Islamic Banking Conference 2007, Manama, 9 December 2007.

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Fellow Governors, Excellencies, distinguished guests, ladies and gentlemen. On behalf of the Central Bank of Bahrain, may I welcome you all to the Inaugural Plenary Session of today's conference. May I take this opportunity to thank the sponsors and organisers of this Conference which this year concentrates on the mechanisms to encourage the growth of the Islamic banking industry whilst containing its risks.

Over the last 20 years we have seen the establishment of several of Islamic banks and financing companies as well as Islamic banking windows as banks have rushed to satisfy the appetite of investors and consumers for Sharia compliant products to finance assets from cars and houses to aircraft and project finance. However as banks have flourished in number, there is increasing evidence that banks will find it difficult to maintain the pace of innovation that marked the 1990s. Islamic banks seem to be increasingly focused on real estate and asset finance but not moving into other financial or liquid instruments with active secondary markets. Perhaps we can take this opportunity to look at the challenges facing Islamic banking and see how the industry, its regulators and stakeholders may respond.

The first challenge is the success of Islamic Banking. The sensational growth that has brought Islamic banks such high profits over the past five years coupled with high levels of liquidity have meant that Islamic banks have not had to fight for funding or ideas. The result is that we are seeing too many Islamic banks with the same business models and structures.

The availability of plentiful liquidity coupled with the explosion of real estate projects in the MENA region have conspired to breed a level of, dare I say it, complacency in some Islamic banks. Many Islamic investment banks are project-driven and do not have a steady source of "bread and butter" revenue to tide them over any slumps in economic activity. This is in contrast to many of the major conventional banks with loan books, overdraft and credit card facilities to provide steady revenue to cover overheads.

Another challenge facing Islamic banks is the multiplicity of Sharia boards and judgements. This leads to a lack of homogeneity for some products on the one hand, and a lack of uncertainty by clients as to whether a product developed in one jurisdiction is Sharia compliant in a neighbouring jurisdiction. Islamic financial products need some level of harmonisation in terms of product features to gain mass acceptance. We at the Central Bank of Bahrain are working with the International Islamic Financial Market to set certain standards on some capital and money market products, but banks themselves could work more closely to establish common disclosure standards for the costs of financing.

Additionally, we at the Central Bank have noted the continuing need for high quality human resources within Islamic banks. Islamic banking has been growing so fast that it has been difficult for banks to find enough skilled or qualified staff. This is why the CBB has participated with Islamic institutions in Bahrain in setting up the Waqf fund to provide financial and technical support in upgrading current training programs and introduce new ones. It is hoped that we will begin to see a larger number of financiers qualified in Sharia – related subjects in the near future. Such initiatives can only be to the benefit of Islamic banking and I urge more institutions to participate in the funding and support of the fund and its works.

I think at this point I should talk about governance challenges facing Islamic financial institutions.

A major issue which is growing in importance is Sharia compliance and how to provide a satisfactory framework to assure investors and other stakeholders that the activities of the bank are within the permitted scope of Sharia. Islamic banks have various mechanisms to ensure Sharia compliance in the products and activities of the institution. The first and most obvious body is the Sharia Supervisory Board. This body produces judgements or fatwas on products or structures that the bank intends to provide. The next body is the Internal Sharia Review function which performs post-facto reviews of the activities of a bank. The last body is the external auditor which, in addition to verifying the accounts of the bank, also checks to ensure that the bank correctly followed AAOIFI Sharia standards.

There are differing perceptions about the respective scope of authority of these three bodies and therefore there is a need to reach consensus on the functions of these respective bodies. This is clearly an area where the institutions, Sharia scholars and the standard setters need to agree upon what constitutes best practice and set an agreed set of standards.

The next challenge is that of accounting standards. There are currently some 60 AAOIFI accounting, auditing, governance and Sharia standards. This body of work is testimony to the commitment and continuing efforts of AAOIFI since its establishment in 1990 to the development of accounting and auditing standards for Islamic institutions. However, products continue to develop rapidly and concepts such as “fair value” have come to centre stage. Conventional accounting standards have responded accordingly. Two such examples are IAS 39 and IFRS 7. Corresponding modifications to existing AAOIFI standards have not yet been made. This means that, for rating purposes or competitive reasons, Islamic banks may need to follow IFRS where AAOIFI standards do not fully cover the concerned product or disclosure. This lack of equivalent AAOIFI standards is making difficulties in producing financial statements for Islamic banks. Additionally, both AAOIFI and IFSB standards need to be adopted by more institutions and regulators to reinforce their status as the benchmark standards in Islamic finance.

I trust that the above challenges need to be addressed by regulators, Islamic banks and the support organisations to consolidate the position of Islamic finance. Please accept my best wishes for a rewarding and stimulating conference.

Thank you.