Rasheed Mohammed Al Maraj: Challenges for Islamic finance

Keynote address by His Excellency Rasheed Mohammed Al Maraj, Governor of the Central Bank of Bahrain, at the World Islamic Banking European Summit, London, 8 July 2008.

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Your Excellencies, Ladies and Gentlemen: Good Morning.

It is a pleasure to be here at the inaugural World Islamic Banking European Summit in London. As His Excellency, Shaikh Mohammed, has already mentioned, Bahrain has been home to the World Islamic Banking Conference for the past fifteen years.

Throughout that time Central Bank of Bahrain has been – and remains – a strong supporter of the WIBC. We very much welcome this inaugural European summit, which we regard as yet a further indication that Islamic finance is rapidly moving into the financial mainstream. There is no need for me to repeat the facts and figures about the stunning growth of Islamic finance that Shaikh Mohammed has already referred to. Let me say, however, that I strongly endorse his view that the Islamic financial industry continues to offer enormous opportunities for both Muslims and non-Muslims alike. We at the CBB have a continuing commitment to facilitating the development of the Islamic financial services industry. We issued the first sovereign sukuk in 2001. We were the first regulator in the world to issue a comprehensive set of prudential regulations tailored to the needs of Islamic financial institutions. More recently, we have introduced an innovative approach to the application of Basel II, Pillar 1 requirements to our Islamic banks. We will continue to ensure that all financial institutions in Bahrain adhere to the very highest international standards. Where necessary we will play our part in adapting those standards to the needs of the Islamic financial services industry. In developing this framework we are assisted by the presence in Bahrain of a number of the leading standard setting bodies for the industry. These include AAOIFI, the Accounting and Auditing Organisation for Islamic Financial Institutions and the IIFM, the International Islamic Financial Market, which is doing sterling work in developing standard contracts and associated documentation. Building sound underpinnings, in the form of an appropriate framework of regulation, accounting and contract standardization, is a very important challenge. But it is by no means the only one that the industry must confront as the result of its success.

I would like to take this opportunity to look at some of the other challenges that the industry currently faces as it moves into the financial mainstream. A long-standing issue relates to the multiplicity of Shari'a boards and judgements. This has led to both a lack of homogeneity for some products, and a lack of certainty by clients about the cross-border acceptability of Shari'a rulings. Additionally, there is a continuing need for high quality human resources within the industry. It has been growing so fast that it has been difficult for institutions to find enough skilled or qualified staff. In recognition of this need the CBB established a special Waqf fund in 2006 to finance and publish research and to support training workshops and other educational initiatives. We have also been working with the Bahrain Institute of Banking and Finance to develop new courses on Islamic finance. Despite the importance we attach to each of these challenges, there are three in particular that I would like to highlight today.

The first concerns corporate governance. All financial institutions – whether conventional or Islamic – need high standards of corporate governance as they are entrusted with other people's money. However, this need is particularly great in Islamic financial institutions due to several issues that are specific to their business model. Decisions on profit distribution, for example, require the careful balancing of the interests of multiple stakeholder groups – not just shareholders, as in conventional banks, but the interests of holders of investment accounts as well. Investment account holders are exposed to many of the same risks as shareholders, but lack the same control rights – such as the ability to vote for board members – that are attached to equity ownership. Balancing these different stakeholder interests requires the adoption of strong corporate governance practices, and the standards developed both by AAOIFI and by the Islamic Financial Services Board are vital components of the solution.

The second issue concerns Islamic banks' ability to manage their liquidity. At the CBB we are in the process of developing an Islamic Sukuk Liquidity Instrument. This will be a repurchase agreement which will enable financial institutions, both conventional and Islamic, to access short term liquidity against Government of Bahrain Ijara sukuk issued by the CBB. We have also encouraged the IIFM to develop contracts and documents that can be used for conducting transactions through commodity murabahas. Even so, there is a continuing need for more depth and liquidity in Sharia-compliant money markets and the CBB intends to remain at the forefront of such initiatives. The final challenge is to ensure that the industry's undoubted success does not turn into complacency. The sensational growth of the industry in recent years combined with high levels of liquidity has meant that Islamic banks have not needed to fight for funding or ideas. Newer entrants to the industry have merely tended to copy the strategies they see being successfully pursued by their more established rivals. If I may say so, there is a high degree of "cloning" of business models.

As a result, a very high percentage of Islamic banks have a strategy that is heavily weighted towards real estate and asset finance. They tend to be project-driven and do not have a steady source of "bread and butter" revenue to tide them over any downturns in economic activity. This contrasts with conventional banks with their extensive loan books, overdraft and credit card facilities which provide steady revenue to cover their overheads even in today's challenging markets. The "cloning" of business models leads to financial institutions becoming exposed to the same economic and industrial sectors. The Islamic banking sector as a whole is highly exposed to the property sector – real estate, commercial property and construction – and as events in the advanced markets have recently reminded us, this sector can and does experience significant cycles of activity.

The asset-based business models favoured by many Islamic banks have not been tested in a downturn. We need to remember that a business model which looks robust in conditions of rising asset values and abundant liquidity may not be so when the economic environment changes. The industry needs to respond to these challenges by developing a greater diversity of business models, more diverse and stable income sources, and more rigorous risk management and stress testing techniques to assess its preparedness to deal with any downturn in economic activity. As a central banker I am inevitably preoccupied by risk, especially when it could potentially impact on a significant sector of the financial industry. However, the challenges that I have highlighted are very much the result of the industry's recent success. We all share of the aim of ensuring that the industry remains successful, and this is why it is so important that we recognize and address these challenges.