Rasheed Mohammed Al Maraj: Ensuring stability – international perspectives on creating an effective regulatory framework

Inaugural plenary address by His Excellency Rasheed Mohammed Al Maraj, Governor of the Central Bank of Bahrain, at the 15th World Islamic Banking Conference 2008, Manama, 24 November 2008.

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Your Excellencies, Ladies and Gentlemen: "Salaam Alaikum"

It is a pleasure to participate in this Opening Session, and to have this opportunity to welcome you all to the 2008 World Islamic Banking Conference. This is the 15th Conference of its kind to have been held here in Bahrain, and in July of this year, the first WIBC European Summit was held in London. The inaugural European Summit was yet a further indication that Islamic finance is rapidly moving into the financial mainstream.

I should like to begin by thanking the many distinguished speakers who will be appearing during the Conference, as well as the event organisers and sponsors. Collectively, your contributions are the reasons for the success of this event. I should also particularly like to extend a warm welcome to His Excellency Heng Swee Keat, Managing Director of the Monetary Authority of Singapore. Thank you for being with us today.

The theme of this Session – "Ensuring stability: International perspectives on creating an effective regulatory framework" – is timely in my view.

Until very recently, many commentators and analysts believed that the economies of the GCC were an oasis of calm in the ongoing global financial turmoil. However, since the collapse of Lehman Brothers in mid-September, it has become clear that no part of the world can be immune to the present crisis. We have seen a vastly changed financial landscape, and there is little doubt that the availability of funds and the costs of borrowing are being affected in all parts of the world.

Against the background of this global financial turmoil, it seems a good time to take stock of the prospects for the Islamic financial industry, and to consider in particular how best to ensure the stability of the industry in future.

In recent months as the global financial crisis has deepened, many commentators have pointed out that Islamic financial institutions have escaped relatively unscathed from the severe downturn which is affecting most conventional financial institutions. This certainly presents the industry with an opportunity to continue its rapid and successful growth of recent decades.

However, the fact that Shari'a compliant institutions have avoided significant losses resulting from the global financial crisis does not mean that there are no lessons that they can learn from the fallout. Let me mention three in particular which I believe are particularly relevant – the risks of herding behaviour, the importance of liquidity management, and the importance of sound corporate governance.

The first example I invite you to consider concerns the belief by many conventional banks that lending to sub-prime borrowers represented a viable new business line in which there would be an appropriate risk reward trade-off. The first movers in this market might have found a profitable niche – but once many banks tried to become players in the same market, credit standards became lax and loans were made to borrowers who had little chance of repaying them. Although some banks recognized the risks they did not do enough to mitigate them at a sufficiently early stage. The reason, as the former head of a major bank remarked in explaining his bank's sub-prime related write-offs, is that "if the music is playing, you have to get up and dance."

The sub-prime episode provides an illustration of the herding instinct which has been a recurrent feature of financial markets since their very beginning. Some banks discover a profit opportunity, other banks follow, and before long the oversupply of credit has led to losses.

Although Shari'a compliant financial institutions have been insulated from direct losses resulting from the recent financial crisis, this does not mean that they are not as much subject to herding as are conventional financial institutions. As I have pointed out in the past, newer entrants to the industry have merely tended to copy the strategies they see being successfully pursued by their more established rivals.

As a result, the industry's assets have become heavily weighted towards the property sector – real estate, commercial property and construction. Events in other parts of the world have recently reminded us that this sector can and does experience significant cycles of activity. We also need to remember that a business model which looks robust in conditions of rising asset values and abundant liquidity, may not be so in a changed economic environment.

The industry needs carefully to consider the risks of the widespread adoption of the same business model. Is it that there are genuine profit opportunities that are not being exploited by their competitors? Or is it instead the consequence of merely deciding to follow the herd?

An important part of the regulator's role is to lean against the tendency towards herding that seems to be a perennial feature of financial markets. This is not always a popular role but it is an essential one. For example, by imposing concentration limits, regulators can require banks to hold a more diversified and therefore less risky portfolio of assets. While we recognise that there are advantages to banks in developing expertise in particular economic sectors, there are also significant risks in chasing after the profit opportunities others have already exploited.

While regulators can help to ensure that financial institutions' risks are well diversified, the main incentive for risk diversification needs to come from the industry itself. The industry needs to develop a greater diversity of business models, more diverse and stable income sources, and more robust risk management and stress testing techniques.

The essential consideration in Islamic finance, as in all forms of finance, is to find the right balance between business development and risk management.

A second issue brought to prominence by the recent global financial turmoil concerns financial institutions' liquidity risk management. Conventional financial institutions and their regulators clearly did not pay sufficient attention to liquidity risks in the run up to the crisis. Liquidity has been a source of potential risk for the Islamic financial services industry for some time, particularly given the relative unavailability of short-term, liquid money market instruments that are Shari'a compliant.

To assist Islamic financial institutions to overcome this problem, the CBB has recently developed an Islamic Sukuk liquidity instrument. This is a repurchase agreement which has been designed to enable financial institutions to access short-term liquidity against Government of Bahrain long- and short-term Ijara Sukuk. Despite this important innovation in the CBB's standing facilities, there is a continuing need for more depth and liquidity in Shari'a compliant money markets and the CBB will continue to explore other such initiatives.

A final issue which the recent global financial turmoil has brought to prominence concerns corporate governance. The experience of the conventional financial sector has been a reminder that financial institutions need high standards of corporate governance as they are entrusted with other people's money. While this is true of all financial institutions, the need is particularly great for those which are Shari'a compliant 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 the 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 stake holder 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.

To conclude, although the Islamic financial services industry has been insulated to-date from the effects of the global financial crisis, there are many lessons that Shari'a compliant institutions can learn. The global financial crisis has been a reminder of the importance of risk diversification, of good liquidity management, and sound corporate governance. These are all lessons which the Islamic financial industry needs to bear in mind if it is to continue to enjoy the framework for stability that is essential for its future prosperity.