Rasheed Mohammed Al Maraj: Impact of the current global financial crisis on Bahrain's economy

Address by His Excellency Rasheed Mohammed Al Maraj, Governor of the Central Bank of Bahrain, at the BCCI Seminar "Impact of the Current Global Financial Crisis on Bahrain's Economy", Manama, 18 November 2008.

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Ladies and Gentlemen:

I would like to thank the Chamber of Commerce and Industry for their kind invitation to speak to you at today's Seminar. The topic that they have chosen, "Impact of the Current Global Crisis on Bahrain's Economy" is very timely.

Until only a month or so ago, many commentators and analysts believed that the economies of the GCC would be an oasis of calm in the on-going financial turmoil. We also tended to hear a great deal about the so-called "decoupling" thesis. This was the idea that the emerging economies would continue their recent strong growth despite the economic downturn in Europe and the United States.

However, since the collapse of Lehman Brothers in mid-September, it has become clear that no part of the world will be immune to the current crisis.

What began in September of last year as a crisis in the US real estate market – the so-called "sub-prime" crisis – earlier in this year turned into what we began to call the "Credit Crunch." The losses that US and European banks suffered as the result of their exposure to sub-prime assets reduced their capital and hence their ability to lend. This sharply reduced the availability of credit in Europe and the US, while at the same time both corporate and household borrowers attempted to de-leverage – that is, to reduce the amount of debt outstanding on their balance sheets.

This was the situation that the world economy and financial system was facing until the middle of September. It pointed to a global economic slowdown, but the worst effects would be concentrated in the developed markets. The emerging economies were expected to continue their recent strong growth.

The collapse of Lehman Brothers in mid-September moved the financial crisis into a new and much more unpredictable phase. The immediate effect was a scramble for liquidity in the main international financial centres, and by the large international banks. There was a massive rise in risk aversion in financial markets, reflected in a variety of indicators, including a rise in risk premiums – the margin that financial intermediaries demand for holding riskier assets – and steep falls in global stock markets.

Even in the GCC the crisis has begun to have an impact. Although the GCC countries enjoy strong fundamentals, this has not shielded them from the crisis. Several have experienced significant stock market corrections. Some GCC members have needed to provide support to their banking sectors, either in the form of recapitalization funds, or by providing blanket guarantees of deposits, or by a combination of both. There is plenty of anecdotal evidence that investment projects are being delayed or scaled back.

In the immediate term the CBB's objective has been to ensure that Bahrain's banking system remains on a sound footing. We receive daily reports from the banks of their liquidity positions, and weekly reports of their exposures. We have also encouraged them to bring forward the disclosures of their third quarter results, many of which have now been published.

In the longer term the Global Financial Crisis contains many lessons for both regulators and the financial industry. In particular, it helps to underscore the need for sound risk management, effective internal controls and strong corporate governance at financial institutions. All of these elements are essential to ensure the stability of individual financial institutions and of financial systems.

The role of the regulator in addressing these challenges is crucial. We can provide the guidance and create the appropriate regulatory framework to enable the sound and stable conduct of financial services and financial institutions. The 6-volume CBB Rulebook is at the very core of our regulatory development and enhancement programme.

The importance of sound corporate governance is one issue brought to prominence by the recent global financial turmoil. As Alan Greenspan acknowledged last month in testimony to the United States Congress, an important cause of the crisis was the failure of internal monitoring and control in financial firms. He had assumed, he said, that shareholders in financial firms had adequate incentives to ensure that the firms they owned did not take excessive risks. As shareholders have subsequently found out, risk taking that goes wrong can be very costly to them.

However, Greenspan acknowledged, his assumption turned out to be flawed. Shareholders did not act to prevent excessive risk-taking. The conclusion is clear. If firms lack the incentives for adequate self-regulation then the regulator must step in. This is the aim of our Rulebook requirements on corporate governance and internal controls.

The financial crisis also points to the need for high standards of risk management in financial firms. Improving the risk management practices of banks was an important component of the work already being undertaken by the Central Bank before the financial crisis, and as a result of the crisis we plan to step up our efforts.

In late 2007 we directed all locally-incorporated banks to carry out internal risk management assessments. The initial reports indicated that Bahraini banks have good internal control systems overall. We have also required all locally-incorporated banks to submit risk concentration policy documents. We carried out a review of all banks' policies and risk limits in the summer of 2008, and we are in the process of notifying all banks with observed deficiencies or gaps to address these matters by the end of the year.

A particular issue for risk concentration concerns the extent to which banks are exposed to the real estate sector. Since 2005, we have required banks to report their exposure to the sector in order that we can discuss real estate concentrations by individual banks, and to monitor the system's overall exposure to real estate.

Since late 2007, we have been consulting with the local banks on measures to limit their exposure to the real estate sector. We have issued three consultation papers on real estate with regard to setting formal rules in due course. We have also increased the regulatory risk weighting to real estate to 200% to act as a regulatory constraint on excessive real estate expansion.

Regulation that limits banks' risk taking will never be universally popular. Some shareholders might see it as reducing their ability to make profits, at least in the short-term. But as Alan Greenspan's admission clearly indicates, the pursuit of short-term profitability without regard to the risks that it involves is in no one's interest – particularly not the interests of the shareholders themselves.

I should emphasize, however, that it is not the regulator's job to protect shareholders against excessive risk-taking. Shareholders are the providers of risk capital and should expect to share in losses when risk-taking goes wrong. Instead, we aim to limit risk taking because our responsibility is to protect a bank's depositors against losses.

Depositors are a special category of a bank's creditors for two main reasons. Bank deposits are the main form of savings for many people, especially the less wealthy. Bank deposits are also money, and the insolvency of a bank – especially a large one – can have serious economic side effects by sharply reducing the supply of money and credit to the economy.

Because of their importance to both individual savers and to the wider economy, bank deposits are subject to a special form of protection in the event that a bank becomes insolvent. This protection is usually referred to as deposit insurance.

In Bahrain we have had a deposit insurance system for some years. Until now this has protected deposits up to a maximum of 75% of BD15,000. It is also what is know as an "ex-post" funded scheme in that the required funds can be collected from the other banks only after a bank has already failed. This takes time, and one of the lessons of the recent financial crisis is that it is important that depositors should be compensated promptly after their bank fails.

Reflecting the lessons of the financial crisis, and also the recent development of international best practice standards on deposit insurance, the Central Bank is in the process of finalizing a new regulation on reform of the existing deposit protection arrangements. The purpose of this reform will be to establish a pre-funded scheme. This will be a scheme in which a fund of money is accumulated in advance of the scheme needing to make any payouts to depositors. The fund will be accumulated by regular contributions from the banks that are members of the scheme.

The purpose of all the measures I have described to you is to ensure that Bahrain's financial system remains sound, stable and able to provide the credit that the domestic economy needs. Sometimes these measures might lead to complaints from particular sectors or groups that their access to credit is being impeded, but as a central bank we need to take a broader view of the overall stability of the system. It would be in no one's interests to allow banks in Bahrain to take excessive risks. A sound banking system is one in which firms are well-diversified, have many different revenue sources, and do not concentrate their risks in one particular economic sector. This is one of the most important lessons we can draw from the financial crisis.

Thank you for your attention.