Rasheed Mohammed Al Maraj: Islamic finance and the financial crisis

Keynote address by His Excellency Rasheed Mohammed Al Maraj, Governor of the Central Bank of Bahrain, at the AAOIFI-World Bank Annual Conference on Islamic Banking and Finance, Manama, 14 December 2009.

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Distinguished Guests, Ladies and Gentlemen:

On behalf of the Central Bank of Bahrain, I would like to welcome you to the 11th Annual AAOIFI-World Bank Conference on Islamic Banking and Finance. I should especially like to thank the many distinguished speakers who will participate in this Conference, as well as the event organisers and sponsors. Particular thanks are due to Mr. James Adams, Vice President, East Asia and Pacific Region, World Bank who has travelled to Bahrain to be with us today. We are grateful to the World Bank for their continued support of this important event.

Looking back on the 12 months that have passed since the last AAOIFI-World Bank Conference, it is striking how profound have been the changes in the financial landscape since then.

The last time this Conference took place it was under the shadow of the bankruptcy of Lehman Brothers. This had cast a dark cloud over the world financial system and the global economy. For a period of several weeks it had appeared that no institution was so strong, or so large, that the prospect of its failure was unthinkable. There was widespread risk aversion in financial markets and the reluctance of banks to lend to each other risked creating a vicious downwards spiral. The interbank markets were frozen. Banks that were unable to raise wholesale funding were forced to cut back on their lending. This reduced the availability of credit to otherwise sound borrowers. Rising default rates then in turn fed the perception that lending banks were at risk. And so the cycle took another downward turn.

In response to this downward spiral many governments – especially in the advanced economies – took a series of extraordinary measures, including the provision of liquidity in unprecedented amounts, the provision of recapitalization support, and Government guarantees of deposits. These measures have been successful in breaking the psychology that led to the vicious downward spiral. Although the global economy has not yet fully recovered, the signs of recovery are there and the situation is immeasurably better than 12 months ago.

There are many who might say that the events in the global financial system have little relevance to Islamic finance. Many in the Islamic finance industry point out that it has been sheltered from the impact of the crisis in part because the Shari'a prohibits the excess leverage and speculative financial activities that were at its root. They also take comfort from the fact that many participants in conventional finance, as well as regulators, and policy-makers have begun to ask whether there are lessons to be learned from the principles of Islamic finance which might help avoid future crises.

Recent events have certainly created a great opportunity for the Islamic financial industry. At the same time, however, there is no room for complacency and if the industry is to make the most of the opportunity that has now arisen it will need to ensure that the lessons of the crisis are fully learned.

Some of these lessons are quite general and apply equally to conventional and to Islamic finance. Central bankers and regulators have learned that they must pay more attention to risks that are common throughout an entire sector of the industry. These risks might not be immediately apparent from reviewing the balance sheet or financial statements of an individual institution.

An example of such a risk is when all banks assume that they can exit their speculative positions at the same time. This requires them to assume that financial markets will always remain as liquid as they are in normal times. But if every financial institution is operating on the same assumption, then the point at which everyone tries to rush to the exit will be the point at which financial markets cease to function. There will be only sellers and no buyers. This is what happened in conventional finance when banks invested in structured financial instruments like CDOs and CLOs which they then found they couldn’t sell at any price.

Now some people might believe that because Islamic financial institutions cannot invest in CDOs and CLOs, they must be immune to this problem. But think about the exposure of many Islamic banks to the real estate market. It might be a reasonable assumption for an individual institution that it could exit profitably a property development that it is funding. But when many other institutions are making similar assumptions about the projects they are funding, the industry as a whole may find it difficult to exit its investments without substantial losses or within a reasonable time-frame.

A further lesson of the crisis is specific to the work of the accounting standard setters and thus to AAOIFI. This lesson relates to the importance of disclosure and transparency. Good disclosures ensure that risks can be clearly identified and that market counterparties are able to form a considered view of the value of financial instruments and investments.

The financial crisis involved multiple failures of disclosure and transparency. For example, conventional banks moved assets to Structured Investment Vehicles (SIVs) or “conduits” which did not form part of their normal financial reporting or disclosures. Because these entities were regarded as off-balance sheet they were opaque both to regulators and to the counterparties of the banks that sponsored them.

Similarly, as we now know, the risk disclosures of various structured financial instruments were inadequate to permit purchasers of those instruments to perform a proper assessment of the risk/reward trade-off. Many investors purchased assets which they believed to have a very different risk profile than turned out to be the case.

Again, there are parallels with Islamic finance. The use of off-balance sheet special purpose vehicles has been a feature of the financing model of many Islamic banks. We need to consider whether this gives rise to the same problem of a lack of transparency that arose with off-balance sheet SIVs. Similarly, accounting standards for Islamic finance need to keep pace with financial innovation. There is a lesson in the failure of the accounting of conventional instruments to keep pace with industry developments.

As the G20 leaders recognised in their recent summit meeting, enhanced accounting and disclosure standards must be a key component of the response to the financial crisis. They have commissioned the international standard setting bodies, such as the International Financial Standards Board (IFSB) and from the US Financial Accounting Standards Board (FASB), to review the lessons of the crisis and to amend their accounting and disclosure frameworks accordingly. AAOIFI will have important work to do in ensuring that the framework of transparency and disclosure of Islamic financial institutions will match the enhanced standards that are likely to be forthcoming for conventional finance. I encourage AAOIFI to follow these developments closely and to work on producing revised and new accounting standards to match changes in the field of conventional finance.

The changes that are likely to result from the global financial crisis, including in the accounting and auditing profession, will provide the background to the professional careers of the students whose success we have gathered to recognise today.

I would like to offer my congratulations to these students who have successfully completed the “Certified Shari’a Adviser and Auditor”, and “Certified Islamic Professional Accountant” programmes. Both are challenging courses of study. To complete them successfully has required hard work and commitment. It is an achievement to be proud of, and one that I am sure will serve you in good stead as you further develop your professional careers.

Let me conclude by wishing the graduating students all the best in their future careers, and to wish all the participants in this Conference a very rewarding and stimulating two days.