Rasheed Mohammed Al Maraj: Business models in Islamic finance – challenges and opportunities

Keynote address by HE Rasheed Mohammed Al Maraj, Governor of the Central Bank of Bahrain, at the IFSB seminar on business models in Islamic finance, Manama, 3 October 2010.

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Your Excellencies, Ladies and Gentlemen:

It gives me great pleasure to be here this evening and to have the opportunity to contribute a few thoughts to the important and timely seminar on business models in Islamic finance. I am sure that the morning session provoked many lively debates as the issues considered are of fundamental importance to the future of the Islamic financial industry. As a major centre of Islamic finance, Bahrain wishes to see the industry move from strength to strength. However, this means on occasion being willing to pose some challenging questions for the industry to answer.

We are all aware of the great potential that exists in the Islamic finance field. Following the global financial crisis there has been a resurgence of interest in the Islamic finance model. Some consultants are predicting that the size of the industry, currently estimated at around one trillion US dollars, could double within a decade. These are exciting predictions, but like all predictions they need to be treated with a degree of caution. As the health warnings on investment products constantly remind us, past performance is not necessarily a guide for the future. As a result, projections of spectacular future growth of the industry which rely on extrapolating the growth trends of the last five or ten years may not be the best guide to the future. The industry will only realise the predicted growth trends if it can properly address some fundamental issues, central to which are the business models of Islamic financial institutions.

The rapid growth in the industry in the last decade has meant that few Sharia-compliant financial institutions have been able to achieve significant economies of scale. Many remain comparatively small and focused on niche markets. The result is that we have an industry that comprises many small scale firms engaged in very similar activities and with comparatively high concentrations of risk. As I have said several times in the past, for the long-term health of the industry it is important to generate greater scale and diversity.

Diversification of the industry needs to occur over several different dimensions.

In the first place, diversification is needed of the industry’s exposure to particular economic and industry sectors, such as real estate. Many Islamic financial institutions have built up a comparatively high exposure to the real estate sector. In part, this is the consequence of the requirement for Sharia-compliant institutions to have a real asset to back their financial assets. Nonetheless, these exposures also have a downside, as the experience of the past few years has reminded us. Like conventional financial institutions, some Islamic financial institutions have suffered losses resulting from their exposure to real estate markets around the world. Moreover, because they are frequently the direct owners and developers of real estate projects, Islamic financial institutions have been exposed to wider range of risks than conventional ones.

As the IFSB argued in a recent paper, the events of the past few years should have given the industry a clear signal that it must reduce its reliance on real estate as an asset class. The requirement for a real asset to back financial assets can be met in many other ways than by financing the construction of office buildings, shopping malls or luxury apartments. The industry should look instead at the scope for increasing the finance it provides for productive assets such as factories, ports, mines, and oil processing facilities. Financing these activities may appear less profitable in the short-term, but may be a better proposition on a risk-adjusted basis.

Diversification is also needed of product offerings that will allow Islamic financial institutions to serve their customers better and to generate more stable revenues. Surveys of the Islamic financial industry tend to show that firms have a comparatively narrow range of financial products to offer their clients. Developing a greater product range will not only benefit consumers. It will also create new sources of revenue that tend to be more stable than those generated by cyclical industries such as real estate.

As I said at the beginning of my remarks, it is in the interests of all involved in the industry – regulators, standard setters and above all practitioners – to ensure that it rests on secure foundations. In other words, the industry must be prepared constantly to subject itself to the sort of intellectually rigorous analysis that has been the hallmark of the work of Professor Simon Archer whose contribution to the industry we celebrate this evening.

Throughout his long and distinguished involvement with the Islamic financial industry Professor Archer has assessed its prospects both sympathetically and honestly. While aiming to encourage the growth and development of the industry, he has also recognised that its long-term potential can only be realized if it rests on strong foundations. The long-run objective of a sound and stable industry should not be sacrificed to short-term gain. These sound principles are exemplified by the work that Professor Archer has done over the years, both with AAOIFI and with the IFSB. He has provided an example that everyone involved in the Islamic financial industry should seek to follow. I am sure you will join me in expressing our appreciation of the deep and lasting contribution that Professor Archer has made to the development of Islamic finance.

Thank you for your attention.