Rasheed Mohammed Al Maraj: Regulatory perspectives – strengthening industry foundations to sustain growth in a challenging climate

Keynote address by His Excellency Rasheed Mohammed Al Maraj, Governor of the Central Bank of Bahrain, at the 17th World Islamic Banking Conference, Manama, 23 November 2010.

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Your Excellencies, Ladies and Gentlemen:
"Salaam Alaikum"

It is a pleasure to welcome you once more to the World Islamic Banking Conference. Over the years the Conference has become firmly established as a landmark event not only in the calendar of Bahrain, but also in that of the global Islamic financial services industry. I would like to congratulate the organisers for once again having assembled such a strong list of speakers at this year's event.

A special word of thanks is due to the many distinguished speakers who will be appearing during the Conference, as their contributions are vital to the success. No less important are the contributions made by the sponsors, who have again been generous in their support notwithstanding the challenging economic circumstances of the past year. Collectively, your contributions are the reasons for the great success of the WIBC.

Our topic for this year's Inaugural Session is that of strengthening industry foundations to sustain growth in a challenging climate. This is an immensely important topic, and one to which I have devoted a number of my recent speeches. As I have said in those speeches the aftermath of the financial crisis presents the Islamic financial industry with both an opportunity and a challenge.

The opportunity is clear: according to reliable estimates, the industry now amounts to over one trillion US dollars, and some consultants estimate that it could double in size within a decade. However, as the warnings on investment products remind us, past performance is not necessarily a guide to the future. As the Islamic financial industry grows, it becomes more important than ever to ensure that it rests on secure foundations. Fundamental to this must be a re-evaluation of business models and strategies to ensure that they remain viable in the new, post-crisis financial environment.

It is worth recalling the quite exceptional returns that some Shari'a-compliant financial institutions managed to achieve in the decade prior to the financial crisis. Assets doubled almost every two years, while net income doubled every year. Some institutions were able to earn a return on equity of more than 30 percent and in some cases even more than 40 percent. They were also able to earn an average return on assets approaching 10 percent.

Islamic financial institutions were not alone in posting exceptional returns pre-crisis. The years between 2000 and 2007 were, by any standards, extraordinary ones for the financial industry as a whole. Most financial institutions achieved returns on equity and on assets which far exceeded the average in the preceding decades. As we now know, in the case of conventional institutions, these exceptional rates of return could only be achieved by taking high risks.

Excessive risk-taking was encouraged by an environment of cheap and plentiful liquidity, which meant that conventional financial institutions could massively increase their leverage. For example, just prior to the crisis, one of the big banks was operating with only seven dollars of capital for every 93 dollars of debt. Overall, the ratio of capital to total assets in conventional banks fell by almost half in the ten years after 1997. Much bigger balance sheets were being supported by the same amount of capital. The effect of this increased

leverage was, of course, to boost the return on equity for conventional banks. For example, the return on equity for UK banks rose from 18 percent in 2001 to almost 30 percent in 2006.

Not only did the conventional banks raise their leverage, but they also held fewer liquid assets. Beginning in the early 2000s, conventional banks' holdings of cash and other highly liquid instruments fell sharply and did not begin to recover until the financial crisis forced them to pay more attention to liquidity management. Conventional banks shifted from holding liquid, but comparatively low return, financial instruments into higher yielding financial instruments which were, inevitably, much less liquid. Instead of holding government bills and bonds, they instead invested in higher return assets such as CDOs and other structured financial products. They may have assumed that there would be a ready market for these types of instrument in the event that they needed to obtain extra liquidity, but as we now know that assumption was wrong.

The risks of shifting into less liquid financial assets were made worse by the way in which those assets were funded. Conventional financial institutions increasingly relied on their access to short-term interbank markets to fund relatively long-term assets. As a result, the average maturity on the liabilities side of the balance sheet was shortened, just as the average maturity on the assets side of the balance sheet was being lengthened. Borrowing short to lend long is, of course, fundamental to the business of banking. Even so, there comes a point at which the degree of maturity mismatching is no longer prudent, and we saw with conventional financial institutions that the boundary between prudent and imprudent business conduct had been crossed.

By now I am sure you will be asking what relevance do these comments on the conventional industry have for Shari'a-compliant institutions. My answer is: a great deal.

If we examine carefully the trends in Islamic banking in the years prior to the crisis, we can see that there are important similarities between the practices of Islamic financial institutions and those of conventional ones. This should not be surprising because high returns require high risks, and the high returns achieved by Islamic banks could only be generated by taking on a corresponding degree of risk.

It is not difficult to see the parallels between conventional and Islamic finance during the years prior to the crisis. Just like conventional institutions, Islamic financial institutions increasingly funded long-term assets with short-term funding. Although the assets and liabilities were structured in a Shari'a-compliant manner, the degree of maturity mismatching was just as great as practiced by conventional institutions. In some cases, for example where the asset involved a long-term development project, the degree of maturity mismatching was significantly greater than that practiced by conventional financial institutions.

Islamic financial institutions did not invest in CDOs or other structured financial products, and thus were saved from exposure to the "toxic" debt that triggered the financial crisis. Nonetheless, the assets in which they did invest were just as illiquid as structured financial products, and in the past two years have been just as difficult for them to sell.

Thirdly, like their conventional peers, Islamic financial institutions also greatly increased their leverage. They did so in a Shari'a-compliant manner, but balance sheets expanded on the back of static capital levels, just as they had done in conventional banks. Despite the extraordinary returns earned during the period of rapid expansion, capital was not retained in the institution but was distributed to shareholders in the form of dividends and to staff in the form of bonuses.

Although the parallels between conventional finance and Islamic finance in the years prior to the crisis are not total, there are enough of them to suggest that many of the lessons are the same.

Conventional banks are being forced by market pressures and by regulators to rethink the business models that they developed in the years prior to the crisis. Regulators are forcing them to pay more attention to leverage and the need for high quality liquid assets. Market

pressures are also forcing these banks to become less ambitious in their growth strategies and to concentrate on their core businesses of deposit-taking and lending.

The need for the reinvention of the business model of Islamic financial institutions is just as great. For about 12 months after the crisis first reached this region, there was an understandable tendency to believe that it would be just a temporary interruption to a story of strong growth. Many believed that after a short period of adjustment the abundant liquidity conditions and the easy access to credit that Islamic financial institutions had enjoyed in the years prior to the crisis would quickly return. The funding would be obtained to complete the major projects and end-investors would again open their cheque books.

As the dust begins to settle on the global financial crisis it should now be clear this assumption of a temporary blip can no longer be sustained. It is no longer wise to base business models on the hope that the era of cheap and plentiful liquidity will soon return. The industry and regulators need to recognise that the crisis has produced a fundamental change in the global financial system. One clear result has been to make participants in the global financial markets much more cautious and risk-averse. There now seem little doubt that the days of cheap and abundant liquidity will not return for a very long time.

Inevitably this means that the business models of many Islamic financial institutions will need to be rethought. They will need to build a more broadly-based franchise than in the past. It is very likely that there will be less scope in future for smaller niche players that provide only a limited range of services. Instead, Islamic financial institutions need to build diversified sources of revenue, relying not only on placement and performance fees, but also on the steady stream of income generated by such an unglamorous but essential activities as advisory services, asset management, and providing financial services to retail clients. Diversification of the industry will need to go hand in hand with its consolidation. Larger, more broadly-based financial institutions will be key to the emergence of an industry with more sustainable business models.

As a regulator, there are a number of things that we can do to encourage this process. Increasing the attention that we give to the sustainability of business models in our supervisory assessments is one of them. New regulatory requirements, modeled on the new Basel III framework, will place greater limitations on the use of leverage as well as requiring more attention to be paid to the way that illiquid assets are funded. Finally, new accounting standards may bring back onto the balance sheet of financial institutions assets which have previously been treated as having been securitized.

While regulatory changes might create the conditions for the reinvention of business models, ultimately this is an issue that the shareholders and management of Islamic financial institutions will need to address. By now it should be clear that there can be no return to “business as usual” and that financial institutions will only survive in future if they succeed in developing a more sustainable business model that does not rely on high leverage and excessive maturity mismatching. Developing those new business models will be a great challenge for the industry, but one that I am confident it will be able to confront.

Thank you for your attention.