Rasheed M Al-Maraj: Islamic finance amid the global financial turmoil

Address by HE Rasheed M Al-Maraj, Governor of the Central Bank of Bahrain, at the Islamic Finance Symposium "Islamic finance amid the global financial turmoil – its implication for Japan", Tokyo, 11 November 2009.

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Ladies and Gentlemen:

It is a pleasure to be with you here today and to have the opportunity to participate in this important and timely Symposium on the subject of "Islamic finance amid the global financial turmoil – its implication for Japan." The Symposium is timely because, in the wake of the global financial crisis, there has been a great upsurge in interest in the principles of Islamic finance and the opportunities that the industry presents both inside and outside the Muslim world.

Many industry participants, regulators, and policy-makers have begun to ask whether there are lessons to be learnt from the principles of Islamic finance which might help avoid future crises. At the same time, there has been growing recognition that Islamic finance offers a variety of financing structures that are viable alternatives to conventional finance. Issuers and investors have begun to explore these opportunities in a serious way.

While obviously the greatest upsurge of interest in Islamic finance has been within Muslim majority countries, and within those non-Muslim countries with significant Muslim populations (such as the UK), there is still plenty of scope for you here in Japan to consider the potential of Islamic finance. This is what makes this Symposium so significant.

Let me begin with briefly outlining the main principles of Islamic finance and its potential relevance to Japanese financial institutions. I will then turn to give some background on Bahrain's role in developing Islamic finance and on the part played by the Central Bank of Bahrain (CBB) in particular.

The basic principle behind Islamic finance can be stated quite simply. The operations of Islamic financial institutions are primarily based on a profit and loss sharing principle. An Islamic bank does not charge interest but rather participates in the yield resulting from the use of the funds. Its account holders also share in the profits of the bank according to a predetermined ratio. There is thus a partnership between the Islamic bank and its account holders, on the one side, and between the bank and its investment clients, on the other. This is in contrast with a conventional bank, which mainly borrows funds paying interest on one side of the balance sheet, and lends funds charging interest, on the other.

To avoid using the interest rate instrument Islamic financial institutions have devised a variety of different types of financial contracts which have, as their common characteristic, the concept that risks and rewards are shared between the institution and its customers. In the past decade an important innovation has been the development of an Islamic "bond" market. These tradable securities – known as "Sukuk" – differ from conventional bonds in that the coupon payments on them represent profits on real economic activities rather than the payment of interest. Sukuk are flexible financing instruments that have attracted a wide range of investors and issuers, both Muslim and non-Muslim. These structures have been used by the Governments of the Gulf Cooperation Council, as well as by Indonesia, Malaysia and Pakistan, the German State of Saxony-Anhalt, the World Bank and other governments and corporations.

Because Japan does not have a significant Muslim population of its own, it would be tempting to assume that Islamic finance is therefore of no interest – if you will excuse the pun – to Japanese financial institutions. But this would be to take too narrow a view of the subject. In global terms Islamic finance may still be a relatively small part of the international financial system, but it is one that is rapidly growing. It also provides an opportunity to engage with a very broad investor and issuer base. For example, financial instruments that are structured in a Sharia-compliant manner appeal not only to Muslim investors, for example those based in the countries of the Gulf Cooperation Council, but also to non-Muslim investors as well. The potential investor base for Sharia-compliant instruments is therefore very broad.

From the point of view of Japanese financial institutions, therefore, Islamic finance should be viewed as an important financial innovation comparable to earlier innovations in conventional finance such as the euromarkets or the derivatives markets. Moreover, given the large Muslim population in South East Asia, a focus on Islamic finance could also form part of your strategies for the region. In summary, there is a strong business case for you to develop the capacity to originate Sharia-compliant financial products.

Let me turn now to consider the experience of the Kingdom of Bahrain as a centre for Islamic finance.

In Bahrain, the birth of the Islamic financial sector dates back to 1978 when Bahrain Islamic Bank was established. Islamic banking in Bahrain gained momentum in the early 1980s, with the issue of four new licenses, one of which was an offshore banking unit license, with the remainder being investment banking licenses. During the 1990's, a total of eight licenses were issued to institutions seeking to pursue Islamic banking services. In the past decade the sector has grown strongly along with the number of licensees. Total assets jumped from US$1.9 billion in 2000 to US$26.3 billion by June 2009, an increase of over 12 times. The market share of Islamic banks correspondingly increased from 1.8% of total banking assets in 2000 to 11.1% in June 2009. There are now 26 Islamic banks and 19 Islamic insurance companies (takaful) operating in the Kingdom.

Given the large regional share of Islamic financial institutions which are based in the Kingdom of Bahrain, it is clearly essential to create an appropriate framework for regulating and supervising the Islamic banking sector. This is an important function of the CBB.

The CBB is the single regulator for the financial services sector in Bahrain. We are the only central bank in the region with responsibility for regulating all banking, capital markets, fund management and insurance business under one roof. We have a policy of following international standards very closely, and in the area of Islamic finance, we have been a pioneer in developing prudential standards.

We apply the same principles of sound regulation and supervision to Islamic banks as are applied to conventional banking. We pursue a duel banking system, where Islamic banks operate side by side with their conventional counterparts. In fact, the emergence of Islamic banks in Bahrain drew on the same environment that led to the development of Bahrain as an international financial centre. The CBB affords equal opportunities and treatment for Islamic banks as for conventional banks.

The CBB prides itself, in fulfilling its regulatory responsibilities, on the innovative approach it has taken, applying international best practices and ensuring transparency throughout the whole regulatory process. The CBB has introduced the first comprehensive prudential and reporting framework that is industry-specific to the concept of Islamic banking and finance.

In addition to the application of rigorous regulatory standards, the CBB has also pioneered a range of innovations designed to broaden the depth of the Islamic financial market and to provide Islamic institutions with wider opportunities to manage their liquidity. To ensure that these objectives are achieved, Bahrain hosts the recently created Liquidity Management Centre (LMC) and the International Islamic Financial Market (IIFM).

The CBB also acts as the agent of the Government of the Kingdom of Bahrain in implementing a regular issuance programme of Shari'a compliant short-term Government securities. A series of Government long-term leasing Sukuk have also recently been launched. The leasing Sukuk are the first of their kind to be issued by a central bank.

Let me turn now to the future prospects for Islamic finance. The global economic crisis has forced the financial industry as a whole to reassess its growth prospects for the years ahead. The Islamic financial industry has not been exempted from this reassessment, although there are those who argue that the prospects for Shari'a compliant finance have improved as a result of the crisis.

It has been 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.

Because interest-based transactions are prohibited, Islamic finance encourages business and trade activities that generate fair and legitimate profit. The prohibition on speculative activity also helps to ensure that there is a close link between financial flows and productive activities. These intrinsic properties of Islamic finance have contributed towards insulating it from the potential risks resulting from excess leverage and speculative financial activities. For example, Shari'a compliant financial institutions were unable to invest in the CDOs and other structured financial products – the "toxic assets" – which have been at the centre of the current crisis.

This is not to pretend that the Islamic financial industry does not face some important challenges. Some of them are specific to global economic conditions, as the clients of Islamic financial institutions are no more immune to the global recession that are the clients of conventional banks. However, some of them are more specific to Islamic finance.

First, Islamic finance in its modern form is a relatively young industry. The first Islamic banks were licensed little more than 30 years ago. Of the 26 Islamic finance entities operating in Bahrain, nearly half have been licensed within the past 5 years, and nearly three quarters have been licensed in the past 10 years.

This has several consequences: few Shari'a compliant financial institutions have yet been able to achieve significant economies of scale. Many remain comparatively small and focused on niche markets. Newer entrants to the industry have also exhibited a tendency to copy the business models they see being successfully pursued by their more established competitors. As a result we have an industry which comprises many small-scale firms engaged in very similar activities and with comparatively high concentrations of risk. For the long-term health of the industry it will be important to generate greater scale and diversity.

Secondly, one of the major constraints on generating scale economies is the difficulty in conducting cross-border transactions. This is because there is still considerable variation from country to country on judgements of Shari'a compliance and therefore variations in financing structures and documentation. The International Islamic Financial Market, which is based in Bahrain, has made important contributions to document standardisation, including in collaboration with the International Swaps and Derivatives Association. However, the lack of portability of Shari'a judgements remains a major obstacle to the industry's growth.

Thirdly, although considerable progress has been made in building a regulatory infrastructure for Shari'a compliant finance in recent years, there are still gaps to be filled. A particular area to be addressed remains liquidity management, an issue that the regulators of conventional finance are now beginning to given greater prominence. I am sure that the regulators of Islamic finance can learn much from these developments and we also need to consider what more we can do to help to foster the development of a Shari'a compliant money market.

In conclusion, although the Islamic financial industry has escaped the worst effects of the financial crisis, there are a number of important issues still to be resolved to ensure its continued success. Along with the rest of the financial industry the path ahead in the next few years may not be smooth. But, as I hope I have explained, the Islamic financial industry is one that has enormous potential for future growth. At the CBB we would be glad to share with you our experience and expertise, built up over an entire generation, as you explore the opportunities in this important field of finance.

Thank you for your attention.