Rasheed Mohammed Al-Maraj: Inaugural Plenary Session – "Regulatory perspectives"

Speech by His Excellency Rasheed Mohammed Al-Maraj, Governor of the Central Bank of Bahrain, at the 16th World Islamic Banking Conference – Session 1: Inaugural Plenary Session: "Regulatory perspectives", Manama, 7 December 2009.

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Your Excellencies, Distinguished Guests, Ladies and Gentlemen: "Salaam Alaikum"

It is a pleasure to have the opportunity to welcome you once more to the World Islamic Banking Conference. The 2009 Conference is the sixteenth to be held in Bahrain, and the WIBC has firmly established itself as a landmark event in the calendar. I would like to congratulate the organisers on having assembled such a strong list of speakers at this year's event, which I am sure will be the best yet.

Let me begin by thanking the many distinguished speakers who will be appearing during the Conference, as well as the event organisers and sponsors. Collectively, your contributions are the reason for the success of this event. It also gives me great pleasure to welcome back His Excellency Heng Swee Keat, Managing Director of the Monetary Authority of Singapore. Your presence at the World Islamic Banking Conference for the second year in succession is an indication of the increasingly strong ties between Bahrain and Singapore, and of the important role that Singapore can play in helping to develop the international presence of the Islamic financial industry. I should also like to welcome the other speakers in this Session, His Excellency Aset Issekeshev, the Minister of Trade & Industry from the Republic of Kazakhstan, and His Excellency Khalid M. Al-Aboodi, the Chief Executive Officer and General Manager of the Islamic Corporation for the Development of the Private Sector, part of the Islamic Development Bank Group. We are greatly pleased to have you with us today as well.

When the World Islamic Banking Conference took place a year ago, it was overshadowed by the events that followed the collapse of Lehman Brothers. For a time it seemed that no financial institution was so large or so strong that the threat of its failure was unthinkable. There was wide-spread risk aversion in the financial markets. Interbank markets froze and many banks found it difficult to fund their positions. For a time it seemed that the world financial system was teetering on the brink of total collapse.

The nightmare scenario that seemed to be unfolding before our eyes was averted by the timely and effective intervention of governments around the world. Banks were recapitalized, blanket guarantees of deposits were issued, and central banks provided liquidity in unlimited amounts. These measures were sufficient to stave off catastrophe. Although in Bahrain we did not consider it necessary to resort to some of the extraordinary measures adopted elsewhere, the central bank took a number of policy actions to ensure the continued smooth functioning of our financial markets.

Although Bahrain has not been as badly affected by the crisis as some other financial centres, there is no room for complacency. As 2009 has unfolded, the impact of the crisis on the level of real economic activity has become more apparent. This has fed through to rising credit losses and reduced profitability at many banks. Reduced investor appetite for risk has also had an impact on those banks that follow an "originate to distribute" model, especially those that have funded real estate developments through distributing shares to investors in Special Purpose Vehicles.

More challenging economic conditions affect the Islamic financial industry just as much as the conventional one. As a result, it is essential that the Islamic financial industry recognizes that the crisis has lessons which apply to them as well as to conventional financial institutions.

The first lesson that the industry might usefully learn is the importance of avoiding what might be termed “straight line thinking”. This is the tendency to assume that what held true of recent years will hold true in future as well. For example, the fact that the economy has grown for the last five years at the rate of six or seven percent, leads to the conclusion that it will continue to grow at the same rate indefinitely in the future. As a result, banks and other financial institutions build their business plans and expansion strategies around the assumption of an indefinite period of strong economic growth. These business plans or strategies then tend to come unstuck when growth falls short of expectations as in the past year.

“Straight line thinking” has resulted in poor decision-making throughout the financial industry. Later in this Conference we will hear from Professor Nassim Nicholas Taleb whose book, the Black Swan, has deservedly attracted wide attention for showing the fallacies behind this kind of reasoning. Nonetheless, because the Islamic financial industry is a relatively young one, with many institutions that have not yet experienced a full business cycle, “straight line thinking” seems to have been particularly prevalent in this sector of the industry. In future Islamic financial institutions will need to adopt more conservative assumptions in their business plans and strategies and to stress test them against outcomes which may not be as optimistic as those they originally assumed.

Closely related to “straight line thinking” is the tendency to be carried away on a wave of euphoria. When markets are booming, when every day there seems to be an announcement of a major new project or deal, it is tempting to be carried along by this psychology. Bankers begin to fear that they are losing out on profit opportunities that are being exploited by their competitors. They see their rivals’ ambitious expansion plans and feel that they must jump on board the bandwagon. As a result the industry moves as a herd, all galloping in the same direction at once. Few bother to stop and to consider whether the direction in which they are heading is one that is leading to a cliff.

While an important function of regulation is to work against the herding mentality which has been a feature of financial markets from their very beginning, the primary responsibility for questioning the direction of travel must be with the industry itself. It is the job of prudent bankers to raise awkward questions about the sustainability of their bank’s business model and their ability to generate profits in the long-run and not just in the short-term. It is also worth remembering the words of Warren Buffet that he is fearful when others are greedy, and greedy only when other are fearful.

Thirdly, the crisis has also illustrated the importance of good liquidity risk management. Prior to the crisis, bank management paid too little attention to liquidity risks. They were reluctant to invest in safe, but low yielding liquid assets at a time when much better investment returns could be earned from other financial instruments. They also assumed that it would be possible for them to exit their positions at any time, without considering the possibility that all other financial institutions would be trying to do the same thing at the same time.

The regulators of conventional banks have now recognised the importance of liquidity adequacy in parallel to capital adequacy. New international standards are being developed on liquidity and several regulators, such as the UK’s FSA, have already put forward their own proposals for enhancing liquidity standards. As you are no doubt aware, the CBB recently published a draft Consultation Paper on liquidity standards for conventional banks and were are currently considering similar proposals for Islamic financial institutions.

Liquidity management has, of course, been a long-standing issue for Islamic financial institutions. We recognise that there is a relative lack of Sharia-compliant high quality liquid instruments that could be used to meet a stock of liquid assets test. As you know, the CBB has undertaken a number of initiatives in recent years to assist the Islamic financial sector to overcome this difficulty. Nonetheless, although recognizing that the problem is a difficult one, the management of Islamic financial institutions have a responsibility to ensure that they take appropriate steps to limit the risk of illiquidity to their institutions.

Prudent banking requires management to consider risk adjusted profitability. For example, putting a large proportion of the bank's assets into potentially profitable, but also highly illiquid, real estate development projects may fail to achieve an appropriate risk reward trade-off. If a bank has put all of its assets into long-term illiquid assets, it may show high levels of profitability for a few quarters, but it is unlikely to remain in business for very long.

Finally, let me turn to the role of the Boards of Directors and of senior management. The financial crisis involved failures of corporate governance at many different levels. There is a common pattern behind many of the failed financial institutions of the last 18 months. In many cases, the Chief Executive was a dominant figure who made sure that he alone took all important decisions. There was no culture of open debate and discussion within the institutions, with the result that members of the Board of Directors did not feel able to challenge the Chief Executive's decisions. Many bank Boards lacked banking experts. Individuals were recruited to the Board of banks for their connections rather than for their knowledge of the banking industry and the ability to ask the right kind of questions.

Boards of Directors also failed in their fiduciary duty to consider the interests not just of shareholders, but also of creditors and depositors. Banks are not like other corporations where directors need to consider only the interests of shareholders. Banks have a special position of trust in that they are charged with looking after other people's money. This means the interests of creditors and depositors need to have equal weight with those of shareholders in the decisions taken by the board of directors. Recognition of the directors' fiduciary responsibilities is, therefore, an essential element of corporate governance for banks.

This observation applies with special force to the Islamic financial industry. The fiduciary duty of the Board of Directors of an Islamic financial institution does not only relate to the interests of shareholders, depositors, and other creditors, but also to investment account holders who bear many of the same risks as shareholders, but who lack the same control rights. Boards of Directors and management therefore have a fiduciary duty to consider the interests of a wide range of stakeholders. It is essential that Sharia-compliant institutions reflect this requirement in their corporate governance arrangements.

The four issues that I have mentioned today – avoiding "straight line thinking", avoiding herding behaviour, managing liquidity risks, and high standards of corporate governance – are not the only lessons that can be learned from the financial crisis. However, I believe that these lessons are the ones of greatest relevance to the Islamic financial industry, and ones that it needs to give especially careful attention to in reforming its own practices.

While the financial crisis will result in regulatory changes which will apply to conventional and Islamic banks alike, the primary responsibility for ensuring sound and prudent banking practices must reside with the owners and managers of the banks themselves. Post-crisis reform needs to begin with the industry examining carefully its own practices and considering whether they meet the standards that its various stakeholders have a right to expect. Only by doing so will it be able to sustain the public trust which is an essential component of a successful financial industry. As the financial crisis has shown, there is little point in pursuing short-term profitability if the long-run result is a loss of public trust in the industry itself.

On that note I should like to thank you for your attention and to wish this Conference every success.