Rasheed Mohammed Al Maraj: Global financial architecture – challenges for Islamic finance

Keynote address by His Excellency Rasheed Mohammed Al Maraj, Governor of the Central Bank of Bahrain, at the 7th Islamic Financial Services Board Summit 2010, Manama, 4 May 2010.

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Your Excellencies, Ladies and Gentlemen:

It is a great honour for the Central Bank of Bahrain to be invited to host the 7th Islamic Financial Services Board Summit.

On behalf the Central Bank I should like warmly to welcome you to the Kingdom of Bahrain. To those of you who are returning to Bahrain, it is a great pleasure to have you with us again. To those of you who are visiting Bahrain for the first time, we hope your visit will be a pleasant one and that it will be the first of many.

I would like to congratulate the organisers for their efforts in putting together such a strong programme and for ensuring that we will hear from some extremely distinguished and knowledgeable speakers over the course of the next two days. I would also like to express my appreciation to the sponsors without whose support this Summit would not be possible.

As one of the founding members of the IFSB the Central Bank of Bahrain has been a strong supporter of its work, as both a standard setting organisation and as an organisation that promotes greater awareness of Islamic finance. It has been particularly pleasing to see the IFSB go from strength to strength and for its membership to expand to now include regulatory and supervisory authorities, international financial institutions, as well as market players and professional firms operating in almost 40 jurisdictions. Great credit must go to Professor Rifaat for his role as Secretary-General in ensuring the IFSB's continued development. This will be Professor Rifaat's final year in office and I am sure you will all join me in acknowledging his enormous contribution to the development of Islamic finance and the strong legacy he leaves at the IFSB. Under his leadership it has become established as the leading forum for the Islamic financial industry.

The theme of the 7th Annual Summit is "Global Financial Architecture: Challenges for Islamic Finance". This theme is particularly timely. As the dust settles after the financial crisis it has become increasingly clear that there will be no return to business as usual for the financial industry. In the advanced economies there is a determination to make sure that there is no risk of a repeat of the crisis and an acceptance that in practice this means financial institutions will be smaller and less profitable than in the past.

Governments, central banks and regulators around the world are now busy constructing a new financial architecture. New institutions and new regulations are being put in place. The structure of the financial industry itself is open to review, with some distinguished people questioning whether it is desirable to allow the combination of commercial and investment banking. Some fundamental questions are being asked about the type of financial system that can best serve the economic needs of society. The UK's Lord Turner has even questioned whether the activities of some investment banks have been, in his words, "socially useless".

The Islamic financial industry cannot stand apart from these developments. The fundamental question that the industry now needs to ask is: to what extent has the global financial crisis been a game changer for Islamic finance as well as for conventional finance? The issue is not whether the Islamic financial industry needs to learn lessons from the crisis, but what lessons it should learn and how it needs to adapt in the light of lessons learned from the crisis.

We are all familiar with the rapid growth of the Islamic financial industry in the years before the crisis. In Bahrain we saw the total assets of the Islamic banks jump from US$2 billion in the year 2000 to US$26 billion by the end of the decade. The market share of Islamic banks increased from 1.8% of total banking assets to over 11% in June 2009. The story of the Sharia compliant insurance and asset management sectors was a similar one of strong growth. This pattern was repeated other financial centres with a significant presence of Islamic financial institutions.

In the early days of the crisis there was a widespread assumption that Islamic finance would continue this strong growth into the future. The view of many people in the industry was that it was not at risk from the crisis. The prohibitions on riba and speculation had kept Islamic banks free of the types of structured financial instruments which soon became known as "toxic assets". The interest shown in Islamic finance by conventional institutions that were eager to learn lessons from the crisis added to the feeling that the Sharia-compliant industry would emerge stronger as the interest-based industry stumbled.

I never shared that point of view. I was not convinced that the Islamic financial industry could avoid suffering some fallout from the worst financial crisis in several generations. Therefore I argued in a number of speeches last year that it is important that the Islamic financial industry learns lessons from the crisis and that it amends its business practices accordingly. Recent developments have provided more support for this conclusion.

In the past twelve months we have seen the first defaults by issuers of Sukuk. These defaults have raised many complex legal questions about the rights of Sukuk holders, for example whether they have the right to take ownership of the underlying assets in the event of the issuers' default. Until these legal questions are resolved there will be a long shadow over the Sukuk market, and we have already seen the impact in terms of the volume of new issuance. The further development of this market depends on finding legal certainty and developing mechanisms to deal with issuer defaults.

It is now also clear that Islamic financial institutions have not been insulated from the second-round effects of the crisis. Their customers have been just as badly affected by the economic downturn as have been the customers of conventional banks. Recent events have also illustrated the risks of concentrating too many assets in specific sectors such as real estate. The principles of sound finance – do not concentrate risk, do not rely on collateral with unrealistic valuations – apply equally to Islamic institutions as to conventional ones.

These recent developments are what make the sessions that are planned for the next two days so very timely. I hope that the panels will be able to draw lessons from the crisis for Islamic finance and that they will be able to assess the impact of the new global architecture on the industry. There can be little doubt that new regulatory policies on such matters as capital adequacy and liquidity will have major implications for the standards that are applied to the Islamic financial industry.

One of the most important lessons of the crisis has been the need for good liquidity risk management by financial institutions. Given the problem of liquidity risk management is one that has confronted Islamic financial institutions for a long time, the events of the past two years should give a new sense of urgency to our attempts to find a solution.

Corporate governance is another issue that I believe is very important. Although none of the panels at this Summit is specifically devoted to this subject it has been a focus of the IFSB's work in the past, and I am sure it will be a recurring theme during the next two days.

As I have said in the past, corporate governance is especially important for banks because they have a special task – that of looking after other people's money. This places a heavy responsibility on their boards of directors and senior management. In the case of Islamic financial institutions the responsibility is greater still since they must take into account the interests of investment account holders, who bear many of the risks of shareholders, but without the same control rights that a shareholder would enjoy. This means that ensuring high standards of corporate governance is even more important for Islamic financial institutions than for their conventional peers and it is perhaps the single most important lesson that the crisis has for the Islamic financial industry.

With that thought, let me conclude by congratulating the organisers on having assembled such a distinguished team of panelists and discussants. I am sure the next two days will produce many new ideas and a lot of interesting debate and I wish every success to the 7th Summit of the Islamic Financial Services Board.

Thank you for your attention.