Rasheed Mohammed Al Maraj: Towards the next phase of growth for Islamic banking and finance – a new paradigm for Asia and the Middle East

Opening remarks by HE Rasheed Mohammed Al Maraj, Governor of the Central Bank of Bahrain, at the 1st Annual World Islamic Banking Conference: Asia Summit 2010, Singapore, 14 June 2010.

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Your Excellencies, Ladies and Gentlemen:

I should like to thank His Excellency Minister Lim for his kind words of introduction and His Excellency Heng Swee Keat, Managing Director of the Monetary Authority of Singapore for his kind invitation to participate in this landmark event.

The World Islamic Banking Conference has become an established part of the calendar in Bahrain. Last year's conference was the 16th to be held in the Kingdom. 2009 also saw the WIBC broaden its scope with its first European Summit which was held in London. The present Summit, the first of its kind to be held in Asia, is evidence of the growing geographical scope of Islamic finance which has emerged from being a niche industry to one that has moved into the financial mainstream.

The choice of Singapore as the host for the WIBC's first Asian Summit marks a further step in the globalization of Islamic finance. Singapore's historical role as a bridge in the trade routes linking Arabia, South Asia and South East Asia make it an appropriate venue for such a Summit. Moreover, with its strong infrastructure and reputation for sound and transparent regulation I am sure Singapore will have an increasingly important role to play in the future development of Islamic finance.

The theme of this Session is the Next Phase of Growth for Islamic Banking and Finance. The current phase has certainly been very impressive. From its beginnings a little over 30 years ago, Islamic finance has grown to become an industry – according to some estimates – which amounts to one trillion dollars in assets. Retail banking has been a particularly strong driver of the industry's growth. Interest in Islamic finance has spread from the Middle East and South East Asia to Europe, Russia, the Central Asian Republics, China, and Africa. Islamic finance is now a genuinely global phenomenon.

In Bahrain we have seen a similar pattern of strong growth. Since first licensing Bahrain Islamic Bank in 1978 the sector has grown dramatically. By the year 2000 the assets of the Islamic banks had reached two billion dollars. Last year they stood at 26 billion dollars. The market share of Islamic banks has increased from 1.8 percent of total banking assets to over 11 percent in the same period. The story of the Shari'a compliant insurance and asset management sectors has been a similar one of strong growth.

The question that the industry now needs to consider is how to ensure that this strong growth can continue into the future.

Although there has been a great upsurge in interest in Islamic finance since the global financial crisis erupted over two years ago, there is no room for complacency in the industry. Both to ensure that it can continue to grow strongly in the future, and that it can avoid the sorts of reputational damage that the conventional industry suffered as a result of the crisis, the Islamic financial industry needs to examine its foundations very carefully. The foundations must be strong enough to ensure that they can support the much larger industry that now rests upon them.

Three issues in particular stand out. The first concerns achieving certainty in Islamic financial contracts. Second, the industry's ability to manage risks needs to be enhanced. Third, the regulatory framework needs to keep pace with the rapid growth of the industry, and also to reflect the lessons learned from the global financial crisis. Let me address each of these in turn.

The certainty of Islamic financial contracts has two dimensions. The first, and the best known, is a fact that we are still some way from developing standard documentation which is recognised as Shari'a compliant by scholars from different jurisdictions and from different schools of Islamic jurisprudence. As long as there is a risk that a contract which is recognised as Shari'a compliant by some scholars will not be recognised as such by others, there exists a lack of legal certainty in the industry.

It might be argued that this lack of certainty has not inhibited the industry's growth to-date. Nonetheless it makes it much harder for Islamic financial institutions to operate on a cross-border basis. The result has been that Islamic financial institutions have had a predominantly domestic focus and have not been able to achieve the scale economies that might make them viable competitors to conventional institutions which do enjoy these benefits. The lack of economies of scale also increases the costs of Islamic financial products and thus ultimately the cost to the consumer.

The International Islamic Financial Market (IIFFM), which is based in Bahrain, has been at the forefront of attempts to develop standardised Islamic financial contracts. Working closely with the International Swaps and Derivatives Association, the IIFM has recently drafted a Tahawwut master agreement which provides standardised documentation for Islamic derivatives. The master agreement was endorsed by the IIFM Board of Shari'a Scholars which includes some of the industry's most prominent and widely respected scholars.

While the IIFM documentation brings a more rigorous and robust architecture to the development of Islamic derivatives, it should be seen as merely the beginning of the process. Much more work will be required to ensure that standardised contracts for other Islamic financial products can be developed which have the support of the great majority of Shari'a scholars.

Within the past 12 months, a new dimension to the legal uncertainty of Islamic financial contracts has arisen. Since the global financial crisis began, we have seen the first defaults on Sukuk. These defaults have raised a number of difficult legal questions which are currently before the courts. In particular, they raise questions about the rights of the Sukuk holders in the event of a default by the issuer and in particular whether they have a claim on the underlying asset. It is important that these cases are resolved rapidly and that they create clear precedents and mechanisms for handling defaults in future as otherwise the lack of legal certainty will act as a drag on the development of the Sukuk market.

The second set of issues relate to risk management. This has a number of different dimensions, but two in particular are worth highlighting. The first relates to liquidity risk. The conventional financial industry received a wake-up call during the crisis concerning the importance of understanding, monitoring and controlling liquidity risks. The Islamic financial industry must recognise that it too needs good liquidity risk management. How Islamic financial institutions can manage their liquidity risk given the relative absence of short-term money market instruments has been a problem for the industry for some time. However, the events of recent years should give a greater sense of urgency to resolving these problems and we need to redouble our efforts to find a solution.

A second area of risk management to which Islamic institutions need to give some attention is the problem of limiting the concentration of risk in particular economic sectors or asset types. The industry's preference for a real asset to back financial transactions has, unfortunately, resulted in a relatively high concentration of risk in real estate. As a result, many Islamic financial institutions have asset portfolios which are concentrated on this potentially very volatile sector. The performance of real estate markets in North America, Europe, and in certain parts of the Middle East in recent years have highlighted the risks of excessive concentrations of lending to this sector. It is important that in future the Islamic financial industry should find ways of diversifying its risks and of reducing its reliance on real estate backed assets.

Finally, on the subject of regulation, it is important that we fully incorporate the lessons of the global financial crisis into regulatory frameworks that apply to Islamic financial institutions. Although some people in the industry believe that it escaped relatively unscathed from the global financial crisis, and therefore has nothing to learn from the recent experience of the conventional industry, I do not share this point of view.

Although the Islamic financial industry was relatively insulated from the first round effects of the crisis because it did not invest in "toxic" structured financial products, it has not been able to avoid the second round effects. These have included sharply reduced liquidity in all markets, and the effect of the global economic downturn on the credit-worthiness of all borrowers, including those who are customers of Islamic financial institutions. 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.

The current prudential framework that applies to Islamic financial institutions is based closely on that developed for conventional ones. Although adjustments have been made to reflect the special nature of Islamic financial institutions, the basic framework is similar to that of the Basel II Capital Adequacy Standards and other prudential rules that the Basel Committee has developed over the years. In consequence, as the international standard setting bodies develop new prudential standards that reflect the lessons of the crisis we need to be ready to revise the prudential framework for Islamic financial institutions accordingly. We will need to adapt the new capital adequacy and liquidity standards for conventional institutions to reflect the specific circumstances of the Islamic financial industry.

In conclusion, it should be clear that there is a great deal of work to be done to ensure that the foundations of the Islamic financial industry are sufficiently strong to support the very much bigger structure that now stands upon them. Even so, I strongly believe that if we can ensure that the foundations are sufficiently robust, the Islamic financial industry has a great and profitable future ahead of it.

Thank you for your attention.