# Rasheed Mohammed Al Maraj: Relevance of international standards to the Islamic financial industry

Speech by HE Rasheed Mohammed Al Maraj, Governor of the Central Bank of Bahrain, at the 13th AAOIFI – World Bank Annual Conference on Islamic Banking and Finance, Manama, 23 October 2011.

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Your Excellencies, Distinguished Guests, Ladies and Gentlemen:

On behalf of the Central Bank of Bahrain, it gives me great pleasure to welcome you to the 13th AAOIFI – Annual World Bank Conference on Islamic Banking and Finance.

I should especially like to thank the many distinguished speakers who will participate in the Conference, as well as the event organisers and sponsors. Particular thanks are due to the World Bank for its continuing support. Mr. James Adams, Vice President, East Asia & Pacific Region of the World Bank has again travelled to Bahrain participate in this Conference. It is a pleasure to have you with us.

As in previous years, the Conference agenda deals with a wide range of topics, all of which are important to the future development of the Islamic financial services industry. However, in my remarks this morning I intend to focus on a theme that two of the sessions have in common: the relevance of international standards to the Islamic financial industry. This theme is explored both in session one, which considers the risks associated with using International Financial Reporting Standards by Islamic financial institutions, and in session five which is concerned with the potential risks and difficulties in the implementation of Basel III in Islamic banks.

The question asked by both of these sessions is: How relevant are international standards to the Islamic financial industry? In many ways the Islamic financial industry faces different issues to those that the international standards have been designed to address. For example, the principle of risk sharing is at the core of the Islamic financial industry. It changes the nature of the risks faced by Islamic financial institutions and their customers. Unlike ordinary depositors, the holders of unrestricted investment accounts in theory share some of the risks that in a conventional institution would be borne exclusively by the shareholders of the bank.

However, it is possible to concentrate too much on the differences and not enough on the similarities. While the principles of Islamic finance are very different to those of conventional finance, Islamic financial institutions are still subject to same kinds of risks and to the same laws of economics as are conventional ones. The differences between the two types of financial structure should not blind us to the issues that are common to both.

Let me give some examples.

Basel III requires conventional banks to hold a stock of high quality liquid assets that can be used to meet unexpected deposit outflows. These instruments include highly rated paper issued by sovereigns and by corporates.

The regulators of the conventional industry have focused on the issue of liquidity because, pre-crisis, conventional banks increasingly relied on their access to short-term interbank markets to fund relatively long-term assets. Borrowing short to lend long is, of course, fundamental to the business of banking. Even so, there comes a point of 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.

If we look at 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. 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 Sharia-compliant manner, the degree of maturity mismatching was just as great as was practiced by conventional institutions. In some cases where the asset involved a long-term development project, the degree of maturity mismatching was significantly greater than that practiced by conventional financial institutions.

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 also needs good liquidity risk management. However, Islamic financial institutions find it difficult to manage their liquidity risk given the relative lack of short-term money market instruments in which they can invest. The CBB has been at the forefront of innovation in assisting Islamic financial institutions to manage their liquidity, but more still needs to be done both by regulators and the industry.

So, does Basel III offer a solution? Obviously, Islamic financial institutions cannot invest in interest-based products. This makes the specific liquidity requirements of Basel III difficult to apply to them. There is also the complication that the outstanding stock of Sukuk is not sufficiently large to enable all Islamic financial institutions to meet a liquidity ratio comparable to that mandated under Basel III. Finally, the markets for Sukuk are not always as liquid as those for conventional government bonds and therefore even if an Islamic financial institution invests in them it might not always be able to find a ready buyer when the need occurs.

These are genuine practical difficulties in applying Basel III to Islamic financial institutions. Even so, they should not get in the way of recognizing the important principle that Islamic financial institutions need to take liquidity risk just as seriously as conventional firms need to do. They need to make sure that they keep maturity mismatching to prudent limits. There needs to be a debate about what sort of limits would be prudent. But there is no doubt that limits are needed.

Another issue that Basel III seeks to address is to ensure that banks have sufficient capital to be able to absorb losses on an on-going basis. Standard setters have focused not only on the amount of capital but also on its quality. In the simplest terms, the financial crisis revealed that too many conventional banks had capital that would only absorb losses if the bank went into liquidation. It was not capable of absorbing losses on an on-going basis. Basel III sets out to ensure that bank capital has a stronger ability to absorb losses before a bank goes into liquidation.

It has often been argued that Islamic financial institutions need a different capital structure to conventional ones. Their account holders can expect to share in the risks to which the firm is exposed. This means that, in principle, they should expect to share in losses as well as profits. But a similar assumption was made about investors who held the subordinated debt issued by conventional banks. When those banks failed, instead of taking their share of losses, subordinated debt holders were often protected by the terms of the bail-out.

So, what applies in theory does not always apply in practice. This means that the regulators of Islamic financial institutions also need to pay careful attention to the ability of capital structures to absorb losses on an on-going basis. It has become clear as a result of the financial crisis that the predominant form of bank capital needs to be equity. From an Islamic industry perspective, this has the great advantage that equity is without a doubt Sharia-compliant.

Finally, on the subject of international financial reporting standards, it is important to remember that transparency and consistency in the valuation of assets is every bit as important to Islamic financial institutions as to conventional ones. In fact, it is even more important. Because investment account holders are in principle exposed to similar kinds of risks as the holder of bank equity, it is important that Islamic financial institutions can present their financial results in a clear and understandable form which is comparable between institutions. IFRS may not be the right solution in all circumstances. AAOIFI has done a lot of immensely important work over the years in adapting international standards to the needs of the Islamic financial industry. However, the need to adapt international standards to the needs of the Sharia-compliant industry should not mean that the important underlying principles of transparency and comparability become neglected.

Recognition that international standards are relevant to the Islamic financial industry, even if they should not be blindly copied, will go a long way towards ensuring that the industry has the strong foundations on which to build for the future. Securing strong foundations for the industry is in the interests of everyone involved it, especially those who are just beginning their careers.

This brings me to the second purpose of our meeting today. I would like to congratulate those students who have successfully completed the "Certified Sharia Adviser and Auditor", and "Certified Islamic Professional Accountant" programmes. To have mastered these challenging courses of study has required hard work and commitment from you. It is an achievement that you can be proud of, and one that I am sure will serve you well throughout your professional career.

Let me end by wishing all the graduating students a long, successful, and rewarding career. I also wish all the participants a successful Conference and hope that you will have many stimulating and fruitful discussions over the course of the next two days.

Thank you for your attention.