## Rasheed Mohammed Al Maraj: Managing the challenges of industry globalization

Keynote address by His Excellency Rasheed Mohammed Al Maraj, Governor of the Central Bank of Bahrain, at the 18th World Islamic Banking Conference, Manama, 22 November 2011.

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Your Excellencies, Ladies and Gentlemen: "Salaam Alaikum"

It is a pleasure to welcome you once more to the World Islamic Banking Conference. Over the years the Conference has become firmly established as a landmark event not only in the calendar of Bahrain, but also in that of the global Islamic financial services industry. I would like to congratulate the organisers for once again having assembled such a strong list of speakers at this year's event.

A special word of thanks is due to the many distinguished speakers who will be appearing during the Conference. Their contributions are vital to its success. No less important are the contributions made by the sponsors, who have again been generous in their support. Collectively, your contributions are the reasons for the great success of the WIBC.

The topic of this year's Inaugural Session is that of Managing the Challenges of Industry Globalization: Strengthening Regulatory Frameworks to Accelerate the International Development of Islamic Finance. This is an immensely important topic. As I have pointed out in several speeches since the Global Financial Crisis began over three years ago, it is essential for the future development of the Islamic financial industry that it learns from the mistakes of interest based finance. This includes making sure that it is based on secure regulatory foundations.

In the past 30 years we have seen the growth of a truly global financial system. Financial markets and institutions no longer stop at national borders. For example, the amount lent by banks cross-border in 1983 was $703 billion. By 2008, the year that the financial crisis became global, that figure had risen to $20 trillion. The trends in the banking market were followed by trends in other sectors of the financial industry.

A globalised financial system delivered many benefits. Capital was free to flow where it could obtain the best investment returns. In many parts of the world, foreign capital was responsible for creating new businesses and factories that raised rates of economic growth and provided employment to millions of people. As a result, the process of capital allocation that the global financial system made possible was responsible for lifting countless millions of people out of poverty.

It is important for critics of the global financial system to remember this achievement. It is far from insignificant. At the same time, however, as we now know, there were costs to this achievement. A globalised financial system also provided the perfect mechanism for the transmission of contagion from one part of the world to another.

In the early 1980s, problems in Latin America brought the largest banks in the world to the brink of collapse. In the late 1990s, the Asian countries suffered financial crises as global capital flows reversed direction. In 2007, problems in the mortgage market in the United States almost caused the collapse of the global financial system and gave rise to the first global economic downturn since the Second World War.

There have been many attempts to explain the reasons for the Global Financial Crisis. Most of them agree on the same basic conclusions. First, that excessive rates of saving in some countries were offset by excessive rates of consumption in others. This created the so-called "global imbalances" that resulted in a flood of capital pouring into the advanced economies, setting off a search for yield. This in turn encouraged financial engineering and the creation of CDOs and other structured instruments.

Secondly, these great flows of global capital passed through a financial system that was inadequately regulated. Financial markets and institutions might have become global, but regulation had not kept up. Despite the best efforts of international standard setting bodies like the Basel Committee on Banking Supervision, nationally-based regulators struggled to ensure proper oversight of global banking groups. In many cases, these groups had grown larger than the economies of the countries that were responsible for licensing and regulating them.

Thirdly, institutions that were inadequately regulated were also inadequately managed. Boards of Directors and senior management simply could not know enough about what was going on in large, diverse, and globally active financial groups to understand the full extent of the risks that they were running. Too often, a firm's risk management and internal control systems were not up to the job of ensuring that these large diversified firms could be properly managed and controlled.

Fixing the problems highlighted by the Global Financial Crisis will take time. There has been more progress on some of these issues than on others. Global imbalances, for example, are still large, and will remain so as long as the United States continues to run large deficits.

There are some signs that the shareholders of large global banks, as well as their regulators, are putting pressure on them to downsize and simplify their operations. Some banks have reduced the scale of their overseas activities after the crisis. Law makers in Britain and the United States have been looking at ways of separating the deposit-taking and lending activities of banks from their other operations. And regulators are pressing banks to come up with so-called "living wills" – to plan for the possibility that the bank might fail.

The greatest progress has, however, been made in writing new regulations. At the end of last year the Basel Committee on Banking Supervision published its new Capital Framework for internationally active banks, known as Basel III.

Basel III tries to do several things, but its main aim is to ensure that banks have bigger capital and liquidity buffers, so that they will be less highly leveraged than in the past. When a bank could operate at a leverage ratio of $1 of equity to every $40 of assets, it was clearly too highly leveraged. It meant that losses of as little as two percent on the bank's asset portfolio could wipe out its entire capital. The Basel Committee has, rightly in my view, set out to make sure that in future banks will not be able to operate with so little capital relative to their assets.

How relevant are these developments to the Islamic financial industry?

Islamic finance has been a relative-newcomer to the globalization trend. The industry itself is still comparatively young, having hardly existed 30 years ago. Since then it has recorded impressive rates of growth, but even today's $1 trillion industry is still relatively small on a global scale.

Even so, the Global Financial Crisis has given the Islamic financial industry a great opportunity. The obvious flaws in conventional finance have created great interest in the Islamic financial model. This should provide the basis for the industry to sustain a period of strong growth for the rest of this decade. The growth opportunities are especially strong as Islamic finance has its largest presence in rapidly growing economies that have been least affected by the Global Financial Crisis. They should continue to register high rates of growth in the years ahead.

If Islamic finance is to make the most of these opportunities, it still needs to learn from the mistakes of interest-based finance.

As Islamic financial institutions expand, they need to make sure that their management and control functions keep pace with their growth. As the Global Financial Crisis shows, there is a need for firms, especially those that become internationally active, to make sure that risk management, control systems, and IT are capable of providing an accurate picture of a financial institution's overall risk profile.

Boards of Directors and senior managers also need to ensure that they have the knowledge, expertise, and professional skills to manage businesses that are growing in complexity. Building high quality human capital is an essential building block for the expansion of the Islamic financial industry.

Finally, the regulatory framework needs to keep pace with an expanding industry. The Islamic financial industry is fortunate in that it has several well-established standard setting bodies, including the Islamic Financial Services Board, the International Islamic Financial Market, and the Accounting and Auditing Organization for Islamic Financial Institutions. Over the years, these standard setting bodies have demonstrated their ability to adapt international standards to the needs of the Islamic financial industry.

These bodies now need to take the lead in adapting the new international standards, including Basel III, to the specific circumstances of Islamic finance. Ensuring that firms have strong capital and liquidity buffers should not be seen as an optional extra for the industry, but as an essential foundation for its next stage of growth. The industry will be stronger if it strengthens its foundations, just as the foundations of interest-based finance are now being strengthened.

Thank you for your attention.