

**Singapore Institute of
Banking and Finance**

*“Implications and Opportunities of
the Evolving Financial Landscape”*

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Address

by

**H.E. Rasheed M. Al-Maraj
Governor
Central Bank of Bahrain**

Ladies and Gentlemen:

I would like to thank Mr. Heng Swee Keat, the Managing Director of the Monetary Authority of Singapore, for the kind invitation to address you this afternoon. I am especially pleased to build on the already existing excellent relationship between the Central Bank of Bahrain and the Monetary Authority of Singapore.

Bahrain and Singapore have much in common. Both are comparatively small island states that are linked to the mainland by a causeway. They have few natural resources of their own, with the result that their economies are dependent on acting as major trade and services centres for a wider region. In the case of Bahrain, our financial services sector is over one quarter

of our economy and we provide a financial services hub for companies that wish to conduct business not just in the other member states of the Gulf Cooperation Council, but also in the wider Middle East and North Africa region.

I have been invited to speak to you today concerning the financial crisis and its implications for the global financial industry. I will begin by briefly discussing how the financial crisis has affected the GCC economies. I will then offer a few reflections on the possible shape of the financial services industry after the crisis.

The six member countries of the GCC – Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates – collectively represent the most hydro-carbon centered economy in the world. On average, oil and gas

revenues account for around 80 percent of Government revenue and for around 70 percent of export revenues, while the oil share in GDP stands at almost 50 percent. Our nominal GDP is equivalent in size to that of Canada and, during the present decade, our economies have grown very rapidly, adding and an economy the size of Sweden in terms of aggregate output in the space of just five years.

Given the structure of our economies, it is inevitable that the global economic crisis will make its impact felt primarily through the decline in the oil price. With the price of oil declining from 147 dollars per barrel in July of last year to around 50 dollars per barrel now, the impact on Government revenues, on our balance of payments, and on domestic liquidity has been significant.

The global financial crisis has also impacted on us in many indirect ways. The collapse of Lehman Brothers last September did not have a particularly great financial impact, as few of our banks had direct exposures. Nonetheless, the psychological impact was felt by both households and businesses. The psychological impact dampened what the economist John Maynard Keynes famously called “animal spirits” – the confidence and optimism that underpin decisions on both consumption and investment. In the GCC, as in the rest of the world, there was a marked deterioration in business and consumer confidence in the months after the Lehman collapse.

A further consequence of the Lehman collapse was a substantial outflow of dollar liquidity from all the emerging markets, from which we in the GCC were not

immune. The liquidity impact of the crisis also combined with a general risk aversion which has had an adverse impact on the supply of credit to many emerging economies, including the GCC countries.

As a result of these global financial market developments there were significant stock market corrections in several GCC countries. Some GCC members – although not Bahrain since we did not consider it necessary – provided support to their banking sectors, in the form of additional capital injections, blanket guarantees of deposits, or a combination of both. Even so, the global shortage of credit has resulted in delays to or the rescheduling of some major infrastructural investment projects.

Fortunately, the GCC countries entered the crisis in a strong economic position due to our surplus fiscal positions, export surpluses, and the reserves we had accumulated during the years of high oil prices. As a result, we have been able to take a variety of measures to protect our economies from the impact of the crisis. In particular, governments have committed to protect or increase their levels of spending to offset any reduction in private sector demand.

In addition, the Central Bank of Bahrain has taken a range of actions to help mitigate the impact of the crisis. We have cut interest rates in line with the actions of other central banks, and more recently have reduced our reserve requirements due to declining inflationary pressures. We have also broadened the range of collateral that we will accept in our repo operations to

include long- and short-term Ijara Sukuk issued by the Government of Bahrain. And finally, we introduced a foreign exchange swap facility that allows our local banks to swap US dollars for Bahrain Dinar at no penalty. These measures have gone a long way to alleviate the liquidity pressures that banks experienced in the final quarter of 2008 and as a result we were able to pass the year end with only minimal disruption to our financial markets.

As the International Monetary Fund acknowledged in a recent review of Bahrain's economy, our financial system has withstood the shocks of the past 12 months relatively well. We attribute its strength to several factors: high levels of capitalization, strong shareholder support, and generally conservative banking practices. We also like to believe that an additional factor – and

this should come as no surprise given I am speaking as a regulator – is the generally conservative regulatory regime we have adopted over the years.

Prior to the crisis, our regulatory framework ensured that our banks had adequate capital buffers, that they weren't excessively leveraged or exposed to adjustment in foreign-exchange rates. We also ensured that they followed a conservative loan-to-deposits ratio which limited their exposure to volatile wholesale sources of funding. Some of these policies were not always popular but now many people, including some of the bankers who criticised them at the time, recognise the wisdom of what we were doing. As a result, our banking sector has been in reasonably good shape to weather the global financial storm.

Although a few years ago our approach to regulation and financial stability might have been seen as being excessively cautious, the benefits of this approach are now being recognized around the world. At the CBB we feel that international regulatory best practice is moving in the direction that we have been following for some time. That direction is one shared by many leading emerging market regulators, and the MAS in particular is admired throughout the world for the high standards of regulation it has consistently adopted.

In the years before the crisis the leading emerging market regulators continued to recognize the importance of getting the basics right. This meant applying the type of prudential requirements that in the advanced economies had come to seem outdated. Requirements like ensuring prudent loan-to-value ratios on real estate lending, and

ensuring that banks observed a prudent loan-to-deposit ratio and did not become excessively exposed to volatile wholesale funding.

I am convinced that one of the outcomes of this crisis will be that international standards, such as those set by the Basle Committee, will return to these basics. They will increasingly reflect the reality that regulation needs to constrain risk-taking through some hard and fast limits. These limits must be simple to apply, transparent, and wherever possible, use observable data. Regulators will be less willing to accept banks internal measurements of risk.

While in one respect this process simply involves the regulators in the advanced economies bringing their practices into line with those of the leading emerging

markets, in another respect there will be a global tightening of regulatory standards. As the communiqué from the G20 meeting in London last month made clear, the long-term intention is to increase levels of capital in banking system as a whole. There is also greater emphasis on ensuring high quality capital, particularly equity and reserves, and increasingly capital adequacy will be measured by core capital ratios. Similarly, we can expect to see international standards placing more emphasis on liquidity adequacy, and that banks will need to hold a large stock of high quality liquid assets as a result.

There will also be a need for banks to review their business models. To the extent that gains in profitability in the past decade have been driven by financial innovation, excessive leverage, and proprietary trading

activities, we can expect to see a decline in profitability and in return that banks can earn on equity. Bank management will need to adjust to an environment in which profits must be earned from comparatively unglamorous activities such as lending and providing payments services, and this in turn implies a greater emphasis on cost control. Again, the theme is that of a “back to basics” approach in which banks become simpler, less highly leveraged, and more clearly focused on a set of core competencies.

Finally, we can expect to see two divergent trends in the advanced markets and the emerging markets. In the advanced markets I am sure that there will be some reduction in scale of the large global banks, some of which, it is now clear, have simply become too large to manage properly. By contrast, however, in the emerging

markets there are still economies of scale to be gained from further consolidation and from mergers between banks. Perhaps over time we will begin to see the banking industries of the advanced and emerging economies converge at some mid-point in which advanced country banks are somewhat smaller than now, while emerging market banks are somewhat larger.

In conclusion, it seems to me that emerging market banking systems will change less as a result of this crisis than those in the advanced markets. Nonetheless, industry change will occur, and both regulators and bank management will need to concentrate in future on getting the basics right.

Thank you for your attention.