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SPECIAL FEATURE

Trump and Brexit events highlight the need for more Participation (Islamic) finance

By Khalid Howladar

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Trump And Brexit Events Highlight The Need For More Participation (Islamic) Finance

KHALID HOWLADAR writes on Islamic finance or, to use his preferred and more inclusive term, 'Participation finance', as it is the dramatic political upsets of 2016 – the UK's decision to exit the EU on the 23rd of June and the election of Donald Trump on the 8th November, that signal the ongoing wealth 'exclusion' is going too far and which has encouraged him to write on the topic with the hope of provoking further debate and promoting what he feels is actually an 'old' form of inclusive capitalism.

A global backdrop of increasing financial inequality

The issue of financial inequality first attracted my attention during the global financial crisis (GFC) of 2007 and 2008 but has become increasingly prominent as the quantitative easing (QE) policies pursued around the world failed to stimulate debt-based consumption and sustainable economic growth (particularly in Europe). Although recovery has started to occur in the US, the historical lack of profit-sharing of the economic gains of globalization and technology continue to drive increasing financial stagnation, insecurity and inequality for many on middle and lower incomes.

In many emerging Muslim-majority countries, the growth of Islamic finance has become a matter of public policy and they often look to countries like the prosperous US as an economic and social role-model. Following extensive thought and debate with a wide number of diverse and senior stakeholders, I have concluded that the core principles underpinning Islamic finance, or to use my preferred and more inclusive term 'Participation' finance, are more relevant now than ever.

In my opinion, one of the main drivers of these upsets was, and (more importantly for the future) remain, the exclusion or lack of 'participation' of the middle and lower income segments of the population in the extensive wealth creation of recent decades, often driven by globalization and technology. The Organization for Economic Co-operation and Development (OECD) report – 'The Gap between Rich and Poor' – published in 2015 (Chart 1), highlights that the richest 10% controlled 50% of all household wealth in OECD countries, the top 1% held 18% and the poorest 40% controlled only 3% of wealth – recall that the OECD excludes the poorest emerging market countries, these startling metrics represent trends in advanced economies, most of them democracies.

As many IFN readers will know, Participation finance is the common and a more literal label of Islamic finance popularized in Turkey given the secular political environment two decades ago. It is term that in one word, simultaneously explains the most important – inclusive – principle underlying Islamic finance and emphasizes that such forms of finance are for everyone – not just Muslims, a key consideration when assessing that many of those 'excluded' are in non-Muslim countries. A fact also relevant when assessing the growth potential of the industry.

A vocal rejection of 'exclusive' capitalism

As an internationalist and broad believer in trade for promoting mutual prosperity, I was shocked that the UK, a prominent advocate of free trade with a perceived DNA of tolerance and diversity, had voted to leave the EU (disclosure: I am a UK citizen born in pro-EU London). Until this shock, the UK and indeed Europe were complacent in appreciating that the increased austerity measures, coupled with the financial insecurity of its citizens (post-GFC), were driving increasing feelings of intolerance and isolationism. It is difficult for those already economically pressured to show compassion to 'foreigners' – particularly against a backdrop of rising religious and political extremism.

Next came the US, where a billionaire outsider could show empathy with an angry and an increasingly disenfranchised majority, largely ignored by the 'elite' political establishment in a country with incredible, but concentrated, wealth creation. The same OECD report highlights that when looking at 'Gini points' (a measure for income inequality, with zero being everyone equal and 100 being the worst, unequal score), the US ranked second for inequality at almost 40 points (close to Turkey but behind Mexico at around 47), whereas the OECD average was around 31. The report also revealed that in the US, one of the world's most prosperous countries, over 17% of people lived below the poverty line, a level exceeded only by Chile, Turkey, Mexico and Israel.

Participation finance favors (productive) asset-backed finance over consumption-driven leverage

A McKinsey Global Institute study published in July 2016 (see Diagram 1) – 'Poorer than their Parents' – showed that over 65% of people in advanced economies (around 550mm people) saw stagnant or declining income from 2005-14 compared to less than 2% (<10 mm) from 1993-2005. More specifically, the UK stood at 70% and the US at 81%, among the highest of the countries surveyed. In both countries, the post-GFC economic growth strategy has been to restart the supposed perpetual and debt-based consumption models that – coupled with the excessive financializaton of the economy (such as the securitization and then re-securitization of consumer loans) have contributed strongly to such inequality over the last few decades. Excessive borrowing gave the short-term illusion of an improved standard of living but the fiction was exposed once credit-driven growth evaporated – despite the almost free money provided by QE and households sought to sensibly reduce their debts.

Luckily, there is now increasing awareness and appetite for more equitable and inclusive forms of capitalism. The dominant economic neoliberal ideals (notably promoted by economists Friedrich Hayek and Milton Friedman) of recent decades promote competition over community and deliberately creates a society with 'winners' and 'losers'. Clearly, such policies have a negative impact on equality and are contrary to the goals of most European democracies as well as the social and ethical principles inherent in participation finance. Also, we have seen that coordinated government support for the Islamic sector has been key in promoting its successful growth, particularly in Malaysia, Bahrain, Qatar, dramatically in Oman and soon potentially Turkey. Again, such state intervention in the economy is also highly discouraged under such 'free-market' ideologies.

Cheap debt and economic financialization distorting capital allocation

A key principle of participation finance is the prohibition of interest income. This removes the economic incentives to lend unsecured to finance non-productive assets. Payments on 'bonds' should always be generated from some 'real' economic and/or business activity, hence asset-backed and equity financings are encouraged and inherently Shariah compliant. Many commentators such as Adair Turner (the chairman of the Institute for New Economic Thinking) have noted that the banking sector role in funding new investment is decreasing in favor of increased, debt-fueled speculation. The rapid gains offered by such financialization draws funds and human capital away from longer-term, more broad-based economic activity and can crowd out the 'real' economy.

It should also be highlighted that the promotion of interest income creates an economic asymmetry that enriches the lender but weakens the (retail) borrower who typically gets 'poorer', especially when borrowing for consumption. The lender is incentivized to lend as much as possible up to the breaking-point of the borrower, regardless of any negative longer-term or social impact. Also, funds that could be directed to more sustainable and productive sectors ultimately support cyclical and excess consumption-driven ones.

"When you combine ignorance and leverage, you get some pretty interesting results" – Warren Buffett

Participation finance promotes tangible asset-backed versus unsecured finance. Thus, it becomes more difficult for citizens to leverage heavily for consumption when unsecured debt is discouraged – it simplistically becomes difficult for consumers to 'buy-things-they-don't-need-with-money-they-don't-have'. It should be highlighted that equity investment is a form of asset-backed financing, with the asset being a share in a tangible and productive business. Such constraints on unsecured lending would favor productive investment over such lending and help moderate the leverage-driven shocks to the economy, but would likely reduce growth in the short term.

For corporates, stock-markets reward debt-fueled buybacks – a trend going up since the 1980s. S&P 500 firms are now spending around US$1 trillion a year on share buybacks and dividends, according to a Goldman Sachs report of November 2016. They estimate that the amount paid to equity holders will rise by around 19% in 2017 versus a 6% rise in the amounts invested for growth (R&D, capex, etc). The net leverage of the S&P500 is close to the highest level of the last 40 years (net debt/EBITDA of 1.6x) and the cheap debt (with its well-documented tax benefits) ensures executives focus on financial engineering and the short-term stock prices rather than longer-term objectives. The bulk of corporate employees are excluded from any stock-related compensation and hence unable to participate in the associated 'wealth creation'.

> ***"The promotion of interest income creates an economic asymmetry that enriches the lender but weakens the (retail) borrower who typically gets 'poorer', especially when borrowing for consumption"***

Despite some recent deleveraging, private individuals too are increasingly indebted according to another study – 'Macrofinancial History and the New Business Cycle Facts' – by academics Jordà, Schularick and Taylor, published in October 2016. Private debt in the advanced economies almost doubled from 62% in 1980 to 118% in 2010 with an immense 30% of the increase happening in the decade just before the GFC in 2007. The report highlights that much of the vast debt increase over the last 40 years has been used to fund property assets. This often creates an unvirtuous circle of asset price inflation that again typically benefits the wealthier elements in society, leaving those on lower incomes unable to benefit from another recent (financialized) source of the wealth creation. Participation finance principles (as opposed to the practice) encourages increasing equity co-ownership between bank and buyer, aligning incentives, although such a model would dramatically alter the risk and pricing profile of banks given mortgages represent the dominant asset class on their balance sheets.

With real incomes and the lower-end stagnating in the face of a global and relatively infinite labor supply, retail customers have historically overleveraged in an attempt to improve, or in some cases falsely maintain, their quality of living – an unsustainable approach that has resulted in financial insecurity for many people who now blame their respective governments; this in turn has driven US and UK citizens to vote for a dramatic and nationalistic change but what can be done to make them supporters of integration and free trade?

Participation finance supports a more equitable wealth distribution

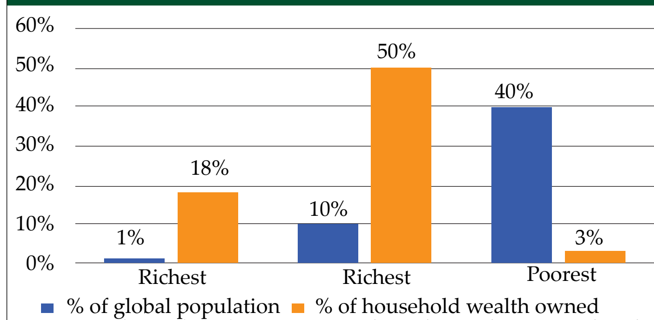
It is the '1%' (or 10%) wealthy described in Part 1 of this article who as business (equity) owners or investors (in equity and property) use debt/leverage to multiply their gains further. Now while it's not clear to me if it's a zero-sum game with the other '99%' of citizens (there is a supposed trickle-down effect), it is a reasonable assumption that the 99% will likely have a much higher proportion of wealth in low/zero-interest cash, with the poorest more likely to have a highest proportion of cash as a share of their net worth.

This cash bias, when combined with the higher (risk-adjusted) gains attributable to equity holders, is helping to inadvertently drive more financial inequality. If, as promoted by participation finance, more of the population were to collectively have more of their cash invested in income-generating assets – such as equities – perhaps as part of their compensation or mandatory savings plans, this would help share some of the global wealth creation (often derived from globalization and technology advances) with the other 99%.

> ***"Strangely, despite being home to some of the world's largest Islamic banks, Gulf governments have been relatively slow to promote widespread long-term economic 'participation' of either their citizens or crucially longer-term expatriates in the local economy"***

With its focus on risk and profit-sharing, the bias in participation finance is inherently toward equity-type or income-generating products (whether in company stocks or in real, tangible assets like real-estate) which the '1%' have long understood is the key to longer-term prosperity. It is it telling that in Malaysia – the most developed Islamic finance economy – the state pension and Hajj funds; Employees Provident Fund (EPF), Kumpulan Wang Persaraan (KWAP) and Lembaga Taibung Haji (LTH) have delivered steady albeit now pressured returns (averaging over 5% during recent years) far more than cash deposit rates over the same period, by investing significantly in equities. With collective assets of over US$200 billion and over 10 million savers, this government-driven approach has supported a much more equitable wealth distribution.

Chart 1: OECD wealth distribution



Source: Keeley, B. (2015), Income Inequality: The Gap between Rich and Poor OECD Insights, OECD Publishing, Paris.

Malaysia leads…

By encouraging/requiring the Malaysian citizenry to invest as opposed to lending (via bank deposits), Malaysia is already encouraging participation finance on a massive scale.
The attractiveness of LTH returns also goes some way to explaining why Islamic banks in Malaysia have relatively weak deposit profiles when compared to their GCC counterparts where no such comparable competition for customer deposits (Islamic or otherwise) exists – but could easily be implemented. Both EPF and KWAP have also recently taken steps to increase their Shariah compliant asset allocation, further embedding participation principles into their investment mandates – this trend will continue.

Malaysia should be proud of this achievement and not seek to endlessly financialize the gains of the real economy but continue to drive more equitable participation in the real economy, particularly in areas such as infrastructure finance. Investment growth versus debt-driven consumption should be the goal. However, it should be noted that equity markets can be incredibly volatile – hence a crucial emphasis on a diversified and longer-term investment approach to help address the issue.

The broadly profitable and increasingly global Islamic banking industry has established an important critical mass by mostly replicating both the strengths and weaknesses of conventional banking but with ethical, social and sustainable objectives often more central to their business and an instant 'brand affinity' with over a billion customers. This sound and robust foundation provides the platform to support a more investment-driven approach to customer savings and to move the sector to what I call Islamic Finance 2.0.

Malaysia's 2013 Islamic Financial Services Act brought clarity around deposit structures and insurance and prompted local banks to move toward offering more v2.0 products to retail customers. This is a crucial step to bringing such investment principles to an even wider segment of the population. The increased focus on 'genuine' investment accounts will build upon the strong, domestic Islamic banking sector and support increased participation in Malaysia's ongoing wealth creation, hopefully avoiding some of the more extreme inequality trends seen in the US and other developed markets.

The GCC can do more…

Strangely, despite being home to some of the world's largest Islamic banks, Gulf governments have been relatively slow to promote widespread long-term economic 'participation' of either their citizens or crucially longer-term expatriates in the local economy. Retail participation in the equity markets tends to be short-term and speculative in nature, hence there is a sizeable potential for more institutional investment through 'social wealth funds', corporate 'end-of-service' liability funds or simply through a broader more proactive retail mandate for some of the existing sovereign funds, although it should be noted that these sovereign wealth funds indirectly support the citizenry through the state funding of a high level of social benefits, moderating some of the inequality.

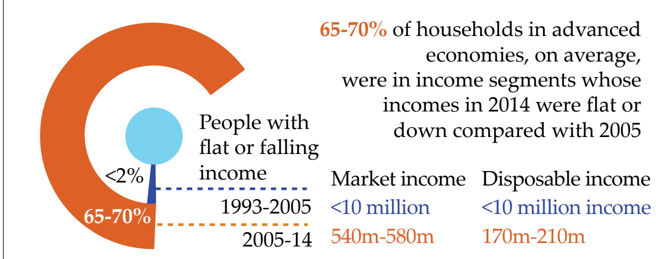
Citizens are demanding more participation in wealth creation

With the democratic upsets of Brexit and Trump, it's clear that a more social and inclusive approach to capitalism is desperately needed to ensure a more equitable, stable and prosperous society, else – as we have already seen – nationalism and intolerance will continue to climb, fragmenting much of the successful post-war integration of the last 60 years.

Gulf and Asian countries should not seek to emulate the neoliberalistic capitalism of the US and parts of Europe unless they wish to ultimately create the same social pressures for their citizens. By taking a more proactive state-led stance to encouraging participation/Islamic finance, the GCC can help ensure better long-term prosperity for their populations, particularly at a time of low-oil induced hardship for their citizens and a transformational time in the sustainability of government finances that requires more investment. Other countries in Asia and Africa too can benefit by ensuring a more inclusive approach to economic development.

This article is quite broad in scope and perhaps limited in depth but I hope it may provide some ideas for more comprehensive academic research. Nonetheless, the following are some ideas for stakeholders to consider:

Diagram 1: People with flat or falling income (advanced economies)



Source: 'Poorer Than Their Parents', July 2016, McKinsey Global Institute

1. Islamic Finance 2.0. Application of new technologies and regulations to facilitate increased awareness around the core principles of participation finance and hence encourage long-term asset/equity investment at the bank retail level, with more product differentiation.

2. The creation of 'social wealth funds' with mandatory contributions from citizens and/or resident expatriates where they do not already exist.

3. The creation of more retail-oriented, low-cost funds within banks, existing pension or sovereign wealth funds.

4. The formalization of funding for statutory corporate employee benefits and liabilities into fund-type structures.

Most critically, the corporate governance, fee and incentive structures around these ideas would be critical to their success and likely there are many more ideas beyond the scope of this piece. I hope that 2017 will see further developments in inclusive capitalism using participation finance principles as the foundation to help the Gulf and Asian states better share the wealth creation of their dynamic economies and hence avoid the inequality driving the discontent highlighted by Trump and Brexit.

About the Author:

Khalid Ferdous Howladar is the Managing Director & Founder of Acreditus, a new strategic consultancy focussed on providing expert risk, rating and Islamic finance advisory specific to the needs of the GCC and Islamic Markets. With over 20 years of experience gained from Moody's, Credit Suisse and JPMorgan, he is a global authority in his respective fields and most recently a consultant to the World Bank Group. In addition to sharing his insightful opinions at forums hosted by a wide variety of institutions such as the IMF, ECB, IIF, IsDB, AMF, IILM, LBS, NYUAD and IFN amongst many others. He has a passion for 'inclusive capitalism' and 'empowering technology'. He has a BEng and MSc in Computing Science from Imperial College and a MSc in Finance from London Business School. He can be contacted at khalid.howladar@acreditus.com and followed on Twitter at @khalidhowladar.

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