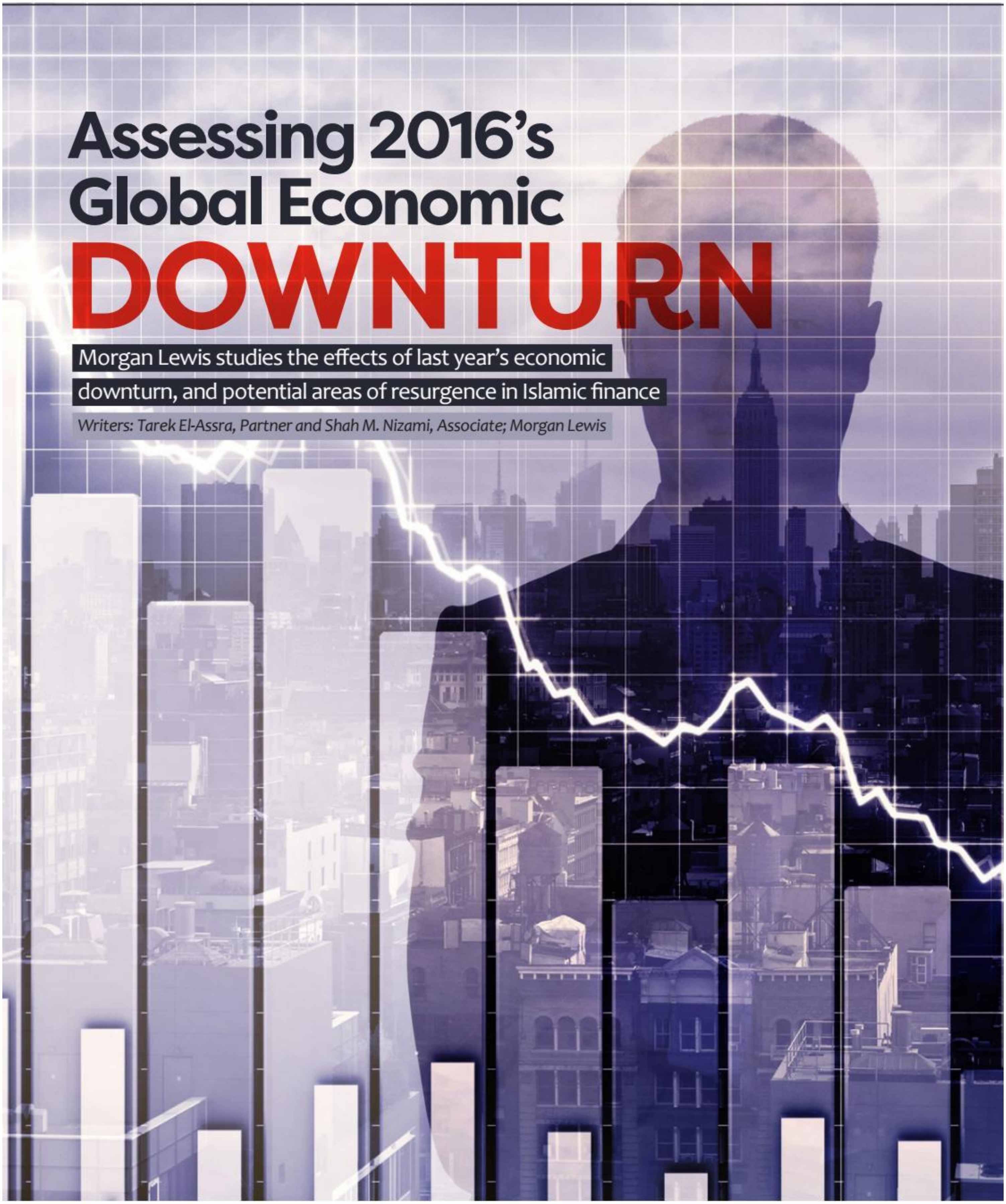

Assessing 2016's Global Economic DOWNTURN

Morgan Lewis studies the effects of last year's economic downturn, and potential areas of resurgence in Islamic finance

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Following the recession of 2007 and discovery of inherent risks in the conventional finance model, the drive to find a more stable financing system led to more focus on the Islamic financing model; in part due to it being based on ethical and social principles, and shared prosperity not present in the conventional finance model.

In the past year, the global banking sector has experienced a slowdown, including Islamic finance. However, it seems that the coming year may see some areas of resurgence in Islamic finance because of, among other things, a rise in oil prices and oil revenues, and growth in existing and new markets.

The downturn

The effects of the US's economy, proposed Brexit in the UK, China's rebalancing effort, and a decline in oil prices all contributed to the slowdown of Islamic finance. The US economy's growth slowed down over the last few quarters of 2016 because of a decline in capital spending in the energy sector. On 23 June, 2016, the United Kingdom passed a referendum to exit the European Union and, as a consequence, the economy experienced weakness due to loss of confidence. China initiated the rebalancing efforts a few years ago due to the amount of investment made in manufacturing industries outstripping demand for goods made by such manufacturing industries. China's economy has experienced and will experience slow growth in the short-term, as such rebalancing lays the foundations for long-term growth.

Islamic finance also experienced a downturn in 2016 due to a slowdown of the economies of the Middle East as a result of steep decline in oil prices, and a lack of uniformity in Islamic finance regulation. Oil prices bottomed out in the mid-$20s in early February, 2016 due to oil supplies piling up in storage as a result of resilient shale production and rising output from OPEC.

A continued issue in decelerating the growth of Islamic finance has been the lack of uniformity in regulations governing Islamic finance. Countries such as Saudi Arabia, Iran, United Arab Emirates, Bahrain, and Malaysia are at the forefront of growing Islamic finance, but the differences in approach to Islamic finance by these countries have led to the growth of Islamic finance being constrained. As the situation currently stands, structuring Islamic finance transactions can be complex, and the lack of uniformity in regulations makes Islamic finance transactions potentially cost-prohibitive to a broader set of investors.

The resurgence

While Islamic finance experienced a contraction in 2016, it could experience a resurgence due to a number of factors, including easing of liquidity constraints due to increasing oil prices, new markets and investors, and a drive for conformity in regulations. Oil prices in 2016 bottomed out but started to rise because North American oil producers enacted a number of spending and production cuts, which allowed oil prices

to hit $50, but bounced between $40 - $50 during the rest of year.

In addition to the North American spending and production cuts, OPEC in November, 2016 agreed to cut the output in the first half of 2017, which signalled a change in strategy by OPEC. The current increase in oil prices, albeit not at the $120 level of a few years ago, should lead to an easing of the liquidity crunch. Such easing should increase funds available to be invested in Islamic finance products such as sukuk issuances (i.e., Islamic bonds).

Sukuk issuances could see an increase in issuances from sovereigns, banks and corporates in the Gulf as regional financing needs to increase. Saudi Aramco has announced its intention to launch a sukuk with four banks in its plan to raise as much as $10 - $15 billion in bonds in 2017 to

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finance its capital expenditures. The entry of Saudi Aramco into the sukuk market could be a game-changer given the size of the Company and its proposed bond issuances. Economies in the Middle East have generally been resilient despite mounting political and economic difficulties in the region and countries such as Saudi Arabia, United Arab Emirates, Bahrain, Malaysia, Qatar and Iran will continue to be strong proponents of Islamic finance and driving forces behind its growth.

Additionally, Islamic finance is a budding industry in countries such as the US, UK, and Russia. Due to the recession, investors in the US have started to look at Islamic finance due to its stability, and ethical and social principles. With Islamic finance's inherent aversion to risk and speculation, Islamic financial institutions (i.e., Islamic banks, community banks,

and investment banks and brokerage firms) in the US have started to grow along with the growth of the Muslim population in the country.

The UK has been at the forefront of Islamic finance with London acting as the go-to hub for Islamic finance products because of its proactive approach in incorporating Islamic finance in its regulatory framework. As a signal of its commitment to being at the forefront of Islamic finance, Britain issued a sovereign sukuk in the amount of £200 million on 25 June, 2014 and a tenor of five years.

Finally, the growth of Islamic finance will be helped by a standardisation of the rules and regulations governing Islamic finance products. In an effort to drive standardisation, Bahrain-based Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has put forward a draft standard on centralised sharia boards. The purpose of the draft standard by AAOIFI is to improve corporate governance in the industry. Due to disparate approaches to sharia boards and Islamic finance generally, adopting centralised sharia boards and moving towards a uniform approach to Islamic finance will increase the credibility of the Islamic finance industry and boost the confidence of its clients and investors in Islamic financial institutions, therefore allowing continued growth.

Islamic finance vs. conventional financing

The recession of 2007 highlighted that the conventional finance model, while globally prevalent, is beset by weaknesses due to its exposure to, and ownership of, risky and speculative assets and financial products, together with the creed that maximum profit is the golden rule. Additionally, the conventional finance model aggregates wealth in the hands of a select few and allows for an unfair distribution of risk between the market participants. While the conventional finance model is used by an overwhelming majority of the world due its ease of access, standardised products, and similar standardised regulations; the great recession of 2008 brought the global economy to the brink of a crash. Consequently, the global economy is in need of a rebalancing and recalibration.

Given the downsides of the conventional finance model, Islamic finance could be the white knight the global economy needs in order to prevent future catastrophic economic downturns due to it being governed by ethical and social principles. Islamic finance could be the key as it is governed by the following principles: prohibition against riba (charging of interest and usury), prohibition against gharar (excessive uncertainty and risk), prohibition against maisir (gambling), and prohibition against haram (forbidden) goods and industries (i.e., alcohol, weapon manufacturers, gambling, etc.).

The foregoing prohibitions allow for a financial system that advocates for the just, fair, and equitable distribution of income and wealth during the production cycle. Islamic finance could provide a stable alternative to the conventional finance model but does have the following drawbacks: the majority of Islamic finance products and institutions are limited to the Middle East, Malaysia and other South Asian countries, lack of uniformity in standards and regulations, potential prohibitive costs, lack of exposure to non-Muslim investors, and finding avenues to incorporate Islamic finance within existing regulatory frames in countries such as the US, Russia and other countries.

Islamic finance could be a viable alternative to the conventional finance model if efforts to standardise products and regulations are successful, the global economy is better educated on the advantages of Islamic finance, and there is continued engagement in the international financial world to develop an Islamic finance industry.

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