

Demystifying the Theoretical Framework of Research in Islamic Finance: A Review of Literature

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Demystifying the Theoretical Framework of Research in Islamic Finance: A Review of Literature

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Abstract- This research takes insights into the research on Islamic finance before and after the occurrence of financial crisis to rediscover its linkages with Islamic socialism and capitalism across international boundaries to establish grounds of Islamic finance theoretical framework. It takes extensive review of literature on Islamic Socialism, Capitalism and Islamic Capitalism taking into account differences in practices of Islamic finance in Islamic and non Islamic countries. Research in Islamic finance has great linkages with Islamic socialism, Islamic capitalism and capitalism as affected by the occurrence of financial crisis during the period of research. The originality value of this research work lies in the novel selection of period of research literature, and the discovery of theoretical framework in Islamic finance research, "Islamic socialistic capitalism".

Key Words: *Islamic Socialism, Islamic Capitalism, Capitalism, Islamic Socialistic Capitalism*

JEL Classification: P16, P19, P27, P29

I. INTRODUCTION:

Modern Islamic finance has seen a major hump in the global financial markets during the last decade [2,44]. Its application in more than 70 countries of the world in general and particularly in USA during the crisis of 2008 has shown its ability to protect institutions during the period of crisis [21,24]. This can be considered as a major turnaround for Islamic finance industry, because until 2004 Islamic finance was not very well accepted by western world mainly because of the strong uphold of riba in their economies [8,13]. One of the causes for sluggish growth of Islamic finance in western economies is the fact that Islamic literature failed to prove its legitimacy to be accepted as a new science that can establish as a new direction to in-practice phenomenon of "riba" [12,49]. The concept of market economy, based on the concept of competition between buyers and sellers, that has been on boom during is against the concept of "Tazkia e Nafs" (Meaning controlling your unislamic and beyond means wishes) [13,49]. Comparing the economies of MENA region and western world, the reasons for such unacceptability have been found to be the difference in "free trade" and in the allowance of private entrepreneurship between two regions [1,48].

The concept of Islamic finance has gained importance just in the last century after having been discussed for ages [9,23]. To be very exact it started its modern application in 1963, when an Egyptian bank generated its earnings solely based on Profit & Loss sharing basis [40]. A concerted effort in this direction can be regarded as starting from the year 1973 when Muslim countries resolved to establish a bank for development of Islamic finance in Muslim countries based on the principles of Shariah [46]. This is marked as the first major step officially taken by the Muslim states for promotion of Islamic finance. The purpose of establishing a mechanism for development of Islamic finance is also to disintegrate the flow of funds of Muslims from institutions functioning on the basis of riba [28,42]. With this broad objective in perspective Islamic finance authorities started developing Islamic finance products that can match the conventional finance products but at the same time can also match the Shariah requirements [7,40]. In the initial era of Islamic finance industry the Islamic financial institutions relied on three modes of Islamic finance; Mufawada (based on Musharika & Mudarba), Murabaha (Based on cost plus selling), and Ijarah (Based on the principles of leasing) [14,42].

The research conducted in first decade of the twenty first century shows unprecedented challenges for the growth of Islamic finance on a number of grounds. Firstly, it has to enforce its acceptability as a science that has been denied earlier. Secondly, it has to design and introduce products that can meet the demands of modern day customers; and lastly but most importantly it has to survive the era of global financial crisis that might have eroded the Islamic financial institutions like other biggies!

The concept of Islamic socialism is based on the combination of religious principles, anti capitalism and anti-imperialist politics taking its roots somewhat from Russian revolution. Its existence is normally discussed within the realm of political economy and economic systems; however, the literature on Islamic finance shows that researches in this area are also widely affected by "Arab Nationalism" due to its roots from Arab regions. Concurrently, as modern financial systems basically have their roots in capitalism [38] and the latest developments in Islamic finance are primarily modifying the conventional financial system products into Islamic products [10,51]. Therefore there is a need to reassess the path of

modern Islamic finance. To have a holistic view of the progress of Islamic finance literature in twenty first century, there is a need to carry out a survey of literature of Islamic finance research. This is important because, the era starting from the year 2003 sets the direction of modern research in Islamic finance after being neglected by the west [15,34]. Accordingly we set the following research objectives for the purpose of our research:

- To locate the roots of modern Islamic finance research from various economic systems.
- To determine the difference in the progress of Islamic finance between Muslim and non Muslim countries.
- Ultimately, to find any new hidden theoretical framework that the Islamic finance research.

Apart from the point of view of Islamic research, the era 2003 to 2006 is also critical because of the fact that the financial crisis started immediately after it. Hence, it will be very crucial to gauge the progress of Islamic finance research in this era which will also help identify what factors have caused success to Islamic finance in various parts of the world, and who have benefitted from it to heal; who to heal and develop; and who to develop straight away.

In order to meet our objectives we have taken reviews of literature on of Islamic socialism, capitalism and Islamic capitalism from the works of prominent researchers in respective areas, and further have conducted a survey of literature of Islamic finance research in different parts of the world on the following issues:

- Progress on Islamic finance in Muslim and non Muslim countries and regions;
- Progress on the issue of corporate governance in Islamic finance
- Progress on the issue of analytical methods in Islamic

The research on above issues have been made on Islamic finance literature to figure out the answers to our following research question based upon our research objectives:

- Whether the research in Islamic finance is affected by Islamic socialism, capitalism and Islamic capitalism simultaneously?

As this is a pioneering research in this area hence this main question will be further explored with the help of following sub research question:

- Whether non Muslim countries are taking more benefit out of Islamic finance research than Muslim countries?
- Is there any the new theoretical framework apart from Islamic capitalism, Islamic socialism and capitalism, being followed in Islamic research?

II. LITERATURE REVIEW

A. Islamic Socialism

[31] working on the roots of Arab socialism terms it as a root cause of Islamic socialism. In his work he points that Islamic socialism has its roots stemmed in the essays of Jamal ud din Afghani's essays written between 1892 to 1897. However, in modern age it got its roots from Russian revolution's anti-imperialist politics as well. According to [17, 31] distinct from absolute socialism, Afghani's school of thought for Islamic socialism involves the materialists and bigoted divines as well. Summing up, in modern age Islamic socialism refers to a socioeconomic system that takes its basic roots from the teachings of the Holy Quran, Ahadith and gets its development roots from Arab nationalism, anti-imperialism, and anti colonialism with shades of democracy of public mandates as well [5,16].

B. Capitalism

Historically it is a system in which economic activities are controlled by the private owners with the objective to maximize their wealth [9,36]. Over the years capitalism has taken many forms that include laissez-faire capitalism, welfare capitalism and state capitalism all of which have three common bases namely, public ownership, social policies and market freedom which are important functions of an Islamic economy as well [53]. However, in recent times the supporters of capitalism have changed this term affected by the ideas of Karl Marx, into "free enterprise" or "private enterprise" and the term "capitalist" has been changed with "investors" or "rentiers" [55].

B. Islamic Finance

a. Literature on Progress of Islamic Finance in various countries

[48] who compares the economy of MENA region with USA, European and Central Asian states opines that MENA countries take more time to establish and close businesses, lack HR processes and have higher quantum of informal markets which mark them with low economic development. [5,54] points that adaptation of Basel principles into Islamic finance system is merely accounting based and therefore requires more improvement. [11,19] point that the progress made in UK even until 2004 was great while the Germany was in infancy stages. They stressed the need of Islamic finance research and development in financial engineering and credit products trading as well.

Conducting a qualitative study for implementation of Islamic banking in South Africa in the year 2005, [22] states that it is in very early stages of development. There was a lot required to be done for promotion of Islamic finance education, Islamic finance boards, Islamic finance research institute and development of local standards. [45] while discussing the challenges of Islamic finance in USA argues that it can prosper in the region rapidly if research can be made to work out terms and conditions to extend bank credit to non Muslims. [35] narrates that Islamic Finance in turkey plays the role of political economics more than economic development. [11,47] argues that in Bahrain and Malaysia debt based products for instance, products based on Murabaha and bay' bi al-thaman al-ajil dominates the application of Islamic finance.

Discussing applications of Islamic finance in Lebanon and comparing it with other countries in MENA region [18] argues that Islamic finance regulations have been introduced in the country in year 2004 however, until 2006 the country had not made significant progress because of some legal issues. For promotion of Islamic finance he argues that the country authorities are required to offer incentives to investors to set up Islamic financial institutions and Islamic research bodies. Also long terms Islamic securities, primary and most importantly secondary markets are required to be established. [12,26] in his research for the period upto the year 2006 in USA states that Islamic financial institutions are losing their moral ground to compete because most of their products are debt like instruments which are mostly based on conventional financial benchmarks. For this reason many conventional finance institutions have also started to adopt Islamic finance because they see very few operational differences. [52] while conducting a research on Islamic project finance in Canada indicate that for its faster development government guarantees are required. [4] while discussing Islamic finance in Australia argue that although Islamic finance is making progress yet it was not governed by the Australian regulatory authority. In giving recommendations to promote Islamic finance in Australia, [6] suggest more government involvement, international connections and research & development. [3] argue that Australian Government need to enact through parliament to make Islamic Finance competitive to practice even in the UK model.

b. Literature Review about Analytical Methods

[33,50] in their research indicate that an attempt to converge Islamic and western economics schools of thoughts on western methods and study references alone is not justifiable. Using their approach based on set theory they opined that Islamic economics mechanism is a vital distinctive approach of managing life based on the concept of Quran and Ahadith, therefore it has its own systematic mechanism to provide analysis and solution of economic problems. [49] opines that Islamic economics is although a separate phenomenon yet it is far less than the standards to be considered as a science merely on the basis of not dealing in interest.

Discussing, the performance appraising of Islamic and conventional banks [19,52] find that performance measurement of Islamic banks is altogether different and hence should be measured on the basis of cost, technical, allocative, scale, and pure technical efficiency scores and not on the basis of conventional accounting ratios. Also [32] finds that Islamic financial institutions perform better in countries where the society is altogether Islamic like, Iran, Saudi Arabia, Sudan. [6] in their ice breaking research on time value of money in Islamic environment state that in Islamic finance matters the adjustment of time value of money is purely dependent upon return on trade and/or business capital; and no addition in the value of money is allowed after it has been created once.

c. Literature Review about Corporate Governance Issues in Islamic Finance

[37] discussing on the concept of governance argues that Islamic finance has been proven to be a vehicle for the implementation of Islamic economics principles, which is making its way to emerge as a power house to enforce Shariah anywhere around the world wherever the Islamic finance will be practiced. Discussing about research and development [25,41] in their research about fundamentals of interest in Islamic realm points that most of the Islamic banking products are debt like instruments e.g., Murabaha, which is not an ideal scenario even according to Islamic ideology. [41] further argues that promulgation of Islamic finance is in fact is based upon existence of Islamic society until which no significant progress in Shariah compliance can be witnessed. The crux of [41] research is to encourage research in Islamic finance based on no exploitation and not on riba free.

[4] while conducting a research on Islamic banking sector find that Islamic finance being practiced is almost like having conventional banking under Islamic names. The products used are debt based like ijarah, and murabaha [39]. [51] acknowledged that Muslim researchers lack appropriate contemporary skills to analyze complex macroeconomic situations. Islamic economics primarily lead by Islamic finance should be developed on altogether different lines with greater Maqasid (Objectives) of Shariah in mind and not maximization of material benefits [20,51]. They not only advise a periodic review of Islamic products, but going one step further they advise revision of global monetary system for a broader perspective of Shariah compliance.

Realizing the growth potential of Islamic Finance in 2006 World Bank issued three documents on Corporate Governance numbered [28,29,30] that deal with challenges faced by Islamic financial institutions and protecting interests of their stakeholders. These documents focus that all countries practicing Islamic finance should develop indigenous regulations to smooth Shariah compliant operations competitive with the conventional counterparts both on financial and non financial basis. Commenting on the issue of governance [43] argues that there exist huge differences in the practices of Islamic finance all over the world which is also causing hindrances in its across the board acceptability and development of universal Islamic financial markets. He suggested introduction of “group ijthad”, which brings people all around the globe together to settle the issues in practices of Islamic finance.

C. Islamic Capitalism

According to [22] this term may sound awkward for the practitioners of Islamic finance in many Islamic countries, however, the fact is that it exists and takes back its roots from the period of Prophet (PBUH) and his caliphs (R.A.) afterwards. The Prophet (PBUH) himself used to conduct business and the caliphs after him Abu Bakar (R.A) and Usman(R.A) were both traders as well [22]. A critical close analysis of literature on Islamic Business practices during the early days of Islam and its comparison with modern capitalism shows that both these economic systems have three major

concepts in common namely: good governance, enforcement of contracts and protection of property rights, upon the basis of which we can form further rules of Islamic Capitalism [22].

III. CONCLUSION

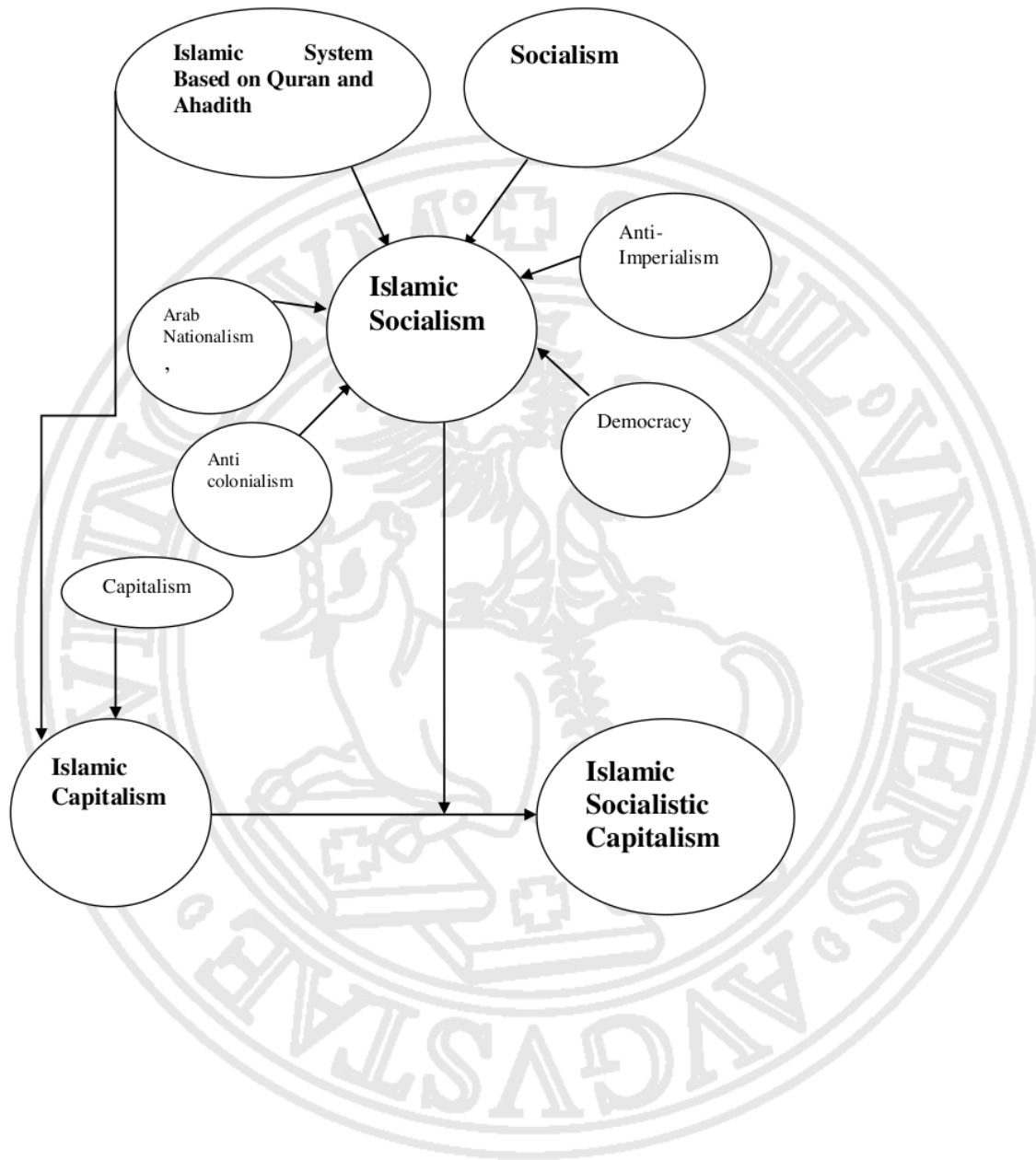
The period of 2003 to 2006 seems to be a take off period for Islamic finance. This is because Islamic finance started to attract the world based on “interest based economies” [8]. A review of literature on various aspects shows that many economies of the world have started skewing towards Islamic finance [7,27]. The concepts of corporate governance got strengthened and rules on it formulated even by the World Bank. Various non Muslim Countries like Germany, Australia, UK, and USA recognized its potential and made legislation for its smooth progress. Even Muslim countries realized the need of attending the call of time and started making appropriate adjustments in their economies to foster results for optimum utilization of Islamic finance potential.

Discussing about the competitive performance environment of Islamic and conventional financial institutions it has been observed that Islamic financial Institutions perform better in an Islamic society than in conventional societies, therefore promotion of Islamic values in daily practice are more important. Keeping in view this phenomenon Islamic financial institutions working in non Muslim societies, or even to deal with Non Muslims, have to devise products which are suitable for their individual requirements and societies. The debate about the legitimacy of time value of money within the realm of Islamic finance has also been clarified that its adjustment is allowed only in the case of trade transactions and not in the

case of merely lending of money in which case it only becomes a matter of changing wealth from hand to hand without any real significant economic contribution. Discussing about the role of state for promotion of Islamic finance it is recommended that the governments should come forward to guarantee the provision of finance to investors to promote economic development in respective economies.

In a nutshell we can opine that researchers of Islamic finance are asking much bigger role of research bodies, states and global regulatory financial bodies like World Bank and IMF to promote the financial institutions working under the realm of Islamic finance. However, as identified the Islamic finance that emerged in practice in most of the countries is more following the path of conventional financial institutions by introducing a majority of debt based products. In this way in a sense Islamic financial institutions have started to diverge from the realm of capitalism, with a cover of Shariah compliance, towards “Islamic Capitalism” characterized by mixture of elements of capitalism and pure Islamic thought [22]. The emergence of concept of government patronage and guarantees and extended role of Islamic financial institutions is required for the betterment of society, and corporate governance. In this way the elements of Islamic socialism have penetrated into Islamic capitalism making the path towards “Islamic Socialistic Capitalism”. Accordingly, by virtue of being stemmed from Arab regions and adopting the route of Islamic capitalism, Islamic finance research seems to have developed the theoretical framework as mentioned in the figure.

Figure : Theoretical Framework of Islamic Socialistic Capitalism:



IV AREAS OF FURTHER STUDY

In this research work we observe Islamic finance research has taken a new theoretical framework of “Islamic Socialistic Capitalism”. This theoretical framework takes its roots not only from Muslim history alone, rather also from societal norms of Arab culture, socialism and capitalism as well. This new theoretical framework therefore opens up a new door for the contemporary researchers of Islamic finance to discuss the issues which were addressed very late by the conventional finance researchers. These include, environmental boundaries available for a recipient and issuer of Shariah compliant finances, restricting the powers of a business owner to manage his business to the extent not to exploit customers like we just witnessed in the latest financial crisis, and most importantly to suggest policies based on permutations of compulsory element of teachings of Islam, with the elements of any of capitalism, socialism or any other societal norms around the world.

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