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A Survey of Contemporary Theoretic Support for Islamic Banking and Finance

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Abstract

This study presents a bird's eye view of the theoretic evolution of Islamic Banking and Finance research in the contemporary world. The study takes account of 206 studies from 7 HEC-recognized journals from across the world. Whereas 15 studies have discussed 16 economic-related theories from an Islamic perspective, majority of the research comes from Malaysia. The subject area is relatively new to the academia and since all these studies stem from Islamic countries, the subject area offers huge scope for other countries, especially Islamic ones, to add to the body of knowledge.

Keywords: *Theories, Islamic Banking, Contemporary.*

Introduction

Islam befriends trade and business through genuine means forbidding exploitation of the buyer by the seller. The Prophet Hazrat Muhammad ﷺ (May Peace Be Upon Him) simplified the capitalist's economic system of Madina through clarity, sophistication, and methodological wisdom. The primary objective of the Islamic economic system is to bring interest-free transactions. Contrasting with the capitalist approach of 'buyer be aware', Islam holds the seller responsible for mischief. The Islamic economic system remained in practice for centuries since the establishment of the Islamic State of Madina (Ahmed & Ashraf, 2020). However, it lost track and capitalistic means of business have been dominating world trade since then, Efforts have been being directed for a few decades to revive the Islamic mode of business. In order to present the end users with a simple account of contemporary developments, this study aims to learn from the recent theory-based publications of the journals dedicated to Islamic Banking and Finance. Data come from the Higher Education Commission of Pakistan (HEC) recognized 7 such journals. We used the term 'Islamic' in the search option which provided us with 39 journals. Further scrutiny shortlisted 8 journals dedicated to Islamic Banking and Finance from different countries of the world. One journal for being in a non-English language could not make to the final list of 7 for further analysis. We selected all 206 papers from 20 issues of these journals that were published either in 2020 (till September 2020) or, in the case of the annual publication, 2019. Skimming through the keywords of these papers reveals that a long list of research issues has attracted scholars from across the globe, ranging from broader categories of Islamic Banking and Finance, Accounts, and Sariah Compliant instruments to a narrower spectrum of topics such as Risk mitigation, Capital Structure, Management and Governance, Microfinance and Macroeconomics, Performance, Audit, Stock, Market, notwithstanding Ethics, and Corporate Social Responsibility. Quite a few studies have also used a wide range of theories to confirm their respective hypotheses. These include Actor-network theory, Agency theory, Deterrence theory, Economic theory, Institutional theory, Islamic Economic theory, Islamic Monetary theory, Modern Monetary theory, monetary theory, Resource Dependence theory, Stakeholders theory, Stewardship theory, Theory of Islamic Jurisprudence, Theory of Reasoned Action (TRA), Trade-off theory, and Unified Theory of Firms. Following sections give a brief account of theory based contemporary research on these varying but relevant components of Islamic Banking and Finance.

Actor-Network Theory:

Sa'id (2020) used this theory to qualitatively investigate how Islamic Banking evolved in multi religious background of Nigeria with 25 semi structured interviews and documentary analysis. Various variables of socio-economic background of the country, especially rich Muslim population and the poorly performing economy, played part in this evolution, highlighting the need for government with multi religious or ethnic population for increased public awareness before embarking upon initiatives that strongly link with one respective segment of the population. Novelty of the study stems from 1) its contextual perspective of numerous influential factors that helped Islamic banking evolve in Nigeria, a country with low respective literature evidence and 2) its unique analysis taking emergence of Islamic banking as a process of actor-network formation.

Agency theory, Resource Dependence Theory, Stakeholders theory, Stewardship theory:

Almutairi & Quttainah (2020) used a theoretical framework combining four different theories, using different variables such as expense preference behavior, loss avoidance, and discretionary loan loss provision, to apply on Shariah as a substitute mechanism for ethical and internal governance. One hundred and sixty four (164) banks with their 3,758 observations over 23 years from 1993 to 2015 provide data for this analysis. The study focuses on finding out the difference of influence, exerted by the foreign directors, on Islamic and conventional banks' managers' opportunistic behavior. The results are different for the two strata of banks. Foreign directors help their respective boards of Islamic banks reduce management's opportunistic behavior and this is untrue for conventional banks. The study also focuses on finding out if religious ethics improve monitoring skills of the foreign directors. The results indicate that their presence in conventional banks' boards is negatively associated with the boards' effectiveness in curbing unethical actions of the management. Expense preference behavior of managers and earnings management are less prevalent in Islamic banks and more prevalent in conventional banks. The study also gives evidence of better monitoring of Islamic banks, than their counterparts, in the presence of foreign directors in their boards. The study can help stakeholders in adopting appropriate means to address the managers' discretion. Hence, it could play its part in subsequently increased transparency, better decision making, enhanced monitoring, and improved quality of accounting. Corporate religious norms inside the boards of directors also play important role in foreign directors' ability to impact management opportunistic behavior. Application of this framework in other Sharia complying financial institutions would help reduce the sample bias as this study includes banks only.

Agency Theory, Trade-off theory, Pecking Order Theory:

Al-Hunnayan (2020) also used Agency theory together with Trade-off theory and Pecking Order theory in a quest to know the factors influencing capital structure of Islamic banks. Since Islamic banks cater for an additional layer of Shariah governance in addition to the central bank's regulations, this study aims to find out effects of this additional layer of governance on capital structure decisions of such banks. Islamic banks working in Gulf Cooperation Council (GCC) countries provide data for 10 years i.e. 2005-1014. The study uses this panel data in OLS regression, fixed and random effect regression to test the hypotheses. The study finds positive association of leverage with firm size and growth opportunity. The former is negatively associated with firm profit, firm's tangible assets, and development of financial market. The study confirms that larger banks have more flexibility and diversity with their higher credit ratings. This helps them curtail their funding cost and marginally improve bank profit coupled with customer base. Higher profit ratios facilitate future investments through internal funds. This also helps in self-reliance. However, this also triggers fast depletion of internal funding in the face of higher growth rate of opportunities for Islamic banks. Developed financial markets tend to avoid higher commission and prefer direct investment in financial markets instead of buying conventional depository products. Islamic banks confirm Pecking Order theory by opting for fund sources that incur minimum cost of transaction and retain maximum information from the competitors. This is why Islamic banks in GCC rely on internal fund sources and avoid external ones. Agency theory marginally explains that the monitoring cost can be reduced by increasing firm's tangible assets. The findings confirm theoretic and empirical literature on capital structure. Results also contribute to comparative analysis of Islamic and conventional banks. The study suggests repetition of the methodology in other parts of the world and also suggests primary data to validate current findings. The study helps decision makers to better understand the market reactions to their capital structure decisions. Researchers can benefit from the study by using these findings to suggest more informed choices of selling or purchasing financial securities. Regulatory bodies can also benefit from the findings to improve their respective regulations. Organizations responsible for setting accounting standards may use these finding to come up with more applicable standards. This would also be useful in preventing any future financial crisis.

Sofi & Yahya (2020) also used Agency theory for their quest to investigate the effects of Sharia Advisory Panel working in Shariah governed environment against conventional corporate settings both in terms of agency cost as well as fund performance. The study adds to the literature in terms of empirical evidence of the Sharia Advisory Panel, as an extra stratum of governance. They based their analysis on mutual funds of both settings thriving in Malaysia covering data from 2008 till 2015. Data give 2,016 observations over the 8 years from a total of 252 Mutual Funds with 172 Conventional Mutual Funds and 80 Shariah Mutual Funds. Observations stem from annual reports and master prospectuses. The study does not suggest the SAP as a viable variable means to improve performance as it adds up the agency cost which further reduces the fund performance. However, using of some other important variables along with SAP may give a more clear analysis. The study also suggests that policymakers should strive to improve the regulation by minimizing administrative costs.

Deterrence theory:

Alshira'h & Abdul-Jabbar (2020) utilized Deterrence theory to find out if tax audit, tax penalty, and tax rate affected sales tax compliance in Small and Medium Enterprises of Jordan. Capturing moderating effect of patriotism was a key feature of this empirical study using primary data approach via questionnaires. Partial Least Square-Structural Equation Modeling (PLS-SEM) helped in analysis of the data. Whereas positive links of tax audit and tax penalty with sales tax compliance are established, the link of the latter with tax rate is somehow insignificant. The theory also confirms the expected moderating effect. The study can help policymakers and tax authorities to come up with better policy measures. Deterrence theory gets its added support, in validating its claims, from the tax related premises.

Ibn e Khaldun's Economic Theories:

Rizkiah & Chachi (2020) probed contemporary relevance of the six famous economic thoughts of Ibn Khaldun, a Muslim scholar who presented his thoughts in his world famous book 'Al-Muqaddima' (The Prolegomenon) almost three hundred years before the birth of Adam Smith, who is believed to be the father of modern economics. Whereas we rarely find references to his work in contemporary literature, the study results show that most of his economic theories are still widely practices throughout the world in one form or the other. However, his theory on money invites scholars for further in-depth research because the world has moved on from gold and silver money to fiat and other sorts of instrument such as cryptocurrencies. The latter were unknown in his times. The world in general and the Islamic countries in special need to benefit from his theories, especially in striving for interest free means of economics.

Institutional Theory:

Siti-Nabiha & Adib (2020) based their research on Institutional theory and documentary analysis of the secondary data in exploring the factors with critical role in institutionalizing the emerging Islamic banking practices in Indonesia. Hence, using primary data in future research may supplement this study. The renaissance of socio-political Islam in Indonesia, in 1980s, influenced changing dynamics of institutional field and thus institutionalization of Islamic banking practices in the country. Subsequently, numerous other factors further influenced these developments. The study also documents variations in priorities of the different factors ranging from compliance with the religious vision to encouraging Muslims to participate in economic activities.

Ayob & Saiyed(2020) also registered lagging behind of Muslims in their participation of economic activities, especially new business opportunities. They also used Institutional theory in their endeavor. The study examines entrepreneurial prevalence among Muslim communities across 88 countries of the globe against formal and informal institutional actors. The study also endeavors the moderating effect of the strategic intervention of these institutions on association of the religion and entrepreneurship. The study relies on various data sources for its data set (2012-2014) such as the World Bank, Global Entrepreneurship Monitor, and Association of the Religious Archive. Muslim communities across the globe seem negatively linked with the new entrepreneurship. Necessity, and not the opportunity, drives Muslim entrepreneurship. This phenomenon renders regulatory environment as well as culture for entrepreneurship short of addressing the Muslims' reluctance towards entrepreneurship, necessitating to empower religious institutions to be more active and catalyst in awareness raising of importance of economic activities for the Muslim population, hence, encouraging their respective participation. The study reveals a gap between theory and practice where contemporary Muslims fall short of practicing religious teachings. The study adds to the body of knowledge from an empirical perspective of involvement of contemporary Muslim population in entrepreneurship across the globe. The study also extends theoretical underpinning for the given mechanism of the association between the two variables. Since this theory has been rarely applied from religio-entrepreneurial perspective, the study suggests vibrant role of institutions to impart religious impacts on entrepreneurship.

Abu Talib et al. (2020) also used Institutional theory in their qualitative study but with a different approach and objective. They used case study and semi-structure questionnaires for data collection and probed to find out various hurdles that prevent adopting Waqf Accounting and Reporting in Waqf institutions of Malaysia and how do the respective institutional pressures impact Waqf reporting. Coercive measures such as government regulations prevent adopting Waqf accounting and reporting. Normative pressures prevent institutions from coming up with applicable standards for Waqf accounting and reporting. Similarly, mimetic pressures hurdle comparability of such reporting among various state Islamic Religious Councils of the country. Board members as well as members of Fatwa Council also affect standardization and subsequent implementation. Similarly, normative as well mimetic isomorphism also slightly affect the process. The study contribute to the theory and potential influence of the religion logic in organizational behavior and developing accounting measures. The study contributes in better understanding of contextual mechanism of Waqf accounting and reporting. This contextual knowledge could be very helpful for the policymakers.

Islamic Economic Theory:

Possumah & Ismail (2020), in their quest to rediscover Islamic economic theory with contextual reference to the influence exerted by contemporary theories on Islamic economics of the present day, disclose self-evident premises of the Islamic economic system encompassing the original sources from the Quran with its distinct economic features. The study also offers a four phased methodology to reconstruct this theory. It first proposes to collect and classify the Quranic verses that particularly deal with the economics. It suggests in the second phase to extend the theoretic understanding of these verses on the bases of exegesis. In third phases it proposes chronology and in the fourth phase it brings micro and macro context of the economics. This combination of the science of exegesis and economics adds to the body of knowledge. The study helps in differentiating between Islamic economics studies from the studies that stem from premises of secular economic thought.

Monetary Theory:

Al-jarhi (2020) using Monetary theory suggests reforms in the Islamic finance in order to save it from being obsolete. The study views the industry trends of contrived sales contracts of selling the present for future money as a grave challenge to the Islamic finance. The study underlines the theoretical rationale of Islamic finance with its macroeconomic benefits. The study views convergence as the main problem of Islamic finance and offers a few proposals to address this problem.

Modern Monetary Theory Vs Islamic Monetary Theory of Value:

Abdullah (2020) used Modern Monetary Theory (neo-chartalist) and Islamic Monetary Theory of Value (metallist) to analyze effects of macroeconomic data for the former theory and adds gold price data with macroeconomics data for the latter theory on nominal and real prices in Malaysia. The exceptional price increase, 425 monetary instances, financial crisis, failure of the current monetary system to protect the store of value function of money in long term, and its inability to address inflation resulting in the monetary and economic instability provide rational for conducting the study to probe genesis for a genuine monetary reform. The study recommends IMTV over MMT for the reasons that whereas the former enables us to maintain purchasing power, low and stable prices over the long term, the latter fails in doing so. MMT seems unable to add any new insights about the monetary mechanism. It does not substantiate its lofty macroeconomic claims that would eventually result in extension of the same inflationary monetary policies that a centralized debt-based monetary system offers. Conversely, IMTV proposes a de-centralized and the intrinsic value for gold or silver that result in achieving the desired outcomes.

Theory of Islamic Jurisprudence:

Eldersevi & Haron (2019) used this theory in their qualitative study examining the adherence of the resolutions of Shariah Advisory Council of Bank Negara Malaysia to the principles of Maslahah (public interest) and their contextual usefulness to the public. The Council's resolutions are based on the principles of Maslahah. The study also examines the opposition to this approach to understand the rejection and implications for the Islamic finance. The study also compares Malaysian fatwa (Shariah pronouncement) issuing authorities with GCC countries. The study finds that SAC-BNM's resolutions are largely aligned with some primary parameters of Maslahah that stem from the sources of Usul-al-Fiqh i.e. must comply with the Quran and Sunnah. However, impact of these resolutions seems week when based on the principles of Ijma (consensus) and Ijtihad (the use of reason to arrive at a knowledge of truth in religious matters), or their impact on the targeted stakeholders. The study brings its analysis from the perspective Usul-al-Fiqh rather than the largely practiced perspective of Fiqh (Islamic Jurisprudence). The study also sheds light on the important components of Maslahah for improved understanding of the concept.

Theory of Reasoned Action (TRA):

Rahman et al. (2020) taking account of Theory of Reasoned Action propose a framework for Shariah Compliant Equity Based Crowdfunding (SEC) for Malaysian Entrepreneurship development. It also accounts for technology acceptance as the theory is also associated with Technology Acceptance Model. The study uses Structural Equation Modeling to analyze opinionated data of 200 entrepreneurs about crowdfunding to raise capital. The study observed reluctance of the entrepreneurs to share their ideas online but they do accept the significant impact of crowdfunding on the capital. The proposed framework would help entrepreneurs mindful of Shariah compliant crowdfunding. The study contributes in developing a workable SEC platform for the respective stakeholders in Malaysia. The study also offers a Shariah Compliant alternative to raise funding through SEC mechanism while it also underlines the increasing needs of entrepreneurs in the country.

Unified Theory of Firms:

This theory is primarily based on four strategies. First, it requires the firms to adopt advance technology. Second, it requires firms to improve intellectual development. Third, it requires firms to observe ethics and morality in their conduct. Fourth, the firms must satisfy their customers' concern. Accounting for these strategies Duasa et al. (2020) used this theory to investigate their primary data that what degree Malaysian firms in the financial sector show their willingness to apply these strategies. The study also looks for the contributing factors that influence the decisions to adopt these strategies. It also focuses on the relationship between these strategies. The study appreciates role of the strategies, underpinned by this theory, in education level of the managers as the higher education level of the managers' correlates with their tendency to adopt strategies more frequently. The study also appreciates the intellectual development as well as the moral conduct of the firms in meeting customer satisfaction. The intellectual development and moral conduct are also highly correlated.

Conclusion:

Fifteen out of 206 studies have discussed 16 theories in their research. Whereas the ratio of theoretic based research against other mechanisms seems reasonably placed, however the fact that majority of these studies stem from only one country i.e. Malaysia accounts for 7 studies indicates need of research from other countries. Turkey, Kuwait, Jordan, Indonesia, and Nigeria chip in with 3,2,1,1, and 1 respectively. Out of these 15 studies, only one caters for global data and one for regional perspective while 12 of the rest are based on country specific perspective. All the studies come from Muslim majority countries while quite a few non-Islamic countries have reasonable share in Islamic Banking but no study has been generated from those countries, not at least in the selected journals. Similarly, bird eye view of the authorship reveals that Islamic Banking and Finance has not been able to draw research curiosity of the scholar community other than one religion. Furthermore, Higher Education Commission of Pakistan categorizes journals in three layers i.e. W, X, and Y category journals belong to top, middle and lower layer respectively. No journal in the world dedicated for Islamic Finance has been placed in the W category according to our search criterion. Three are placed in X and 4 are placed in Y category journals. This shows huge opportunity of research growth in this area. The subject is relatively new to the contemporary academia and it offers significant scope for both the journals as well as scholars.

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