

Global Financialization Effects and the Role of Islamic Finance Institutions

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Abstract

Financialization refers to the growing importance of financial activities as a source of profits in the economy, distinguishing the dominance of the finance sector over all other industries. This includes the gradual change in operations of many traditional manufacturers who have turned to generate income through financial means rather than the mere provision of goods to their customers. Financialization has increased the power of the rentier class within society, the preeminence of maximizing the shareholder value principle among corporate management, the dominance of capital markets over bank-based finance, and the surge of financial trading with the help of new financial instruments and technology. Several studies argue that there is a massive impact on the economic and financial industry since financialization has become prominent around the globe. Therefore, there is a need to come up with structural changes to support and help the financial industry for its betterment. In this paper, we will discuss the effects of financialization in several studies and explore the role of Islamic finance in this regard and how Islamic finance principles can help and support financial institutions to avoid another economic and financial crisis in the days to come.

Keywords: Financialization, Islamic Finance, Globalization, Islamic financial institutions.

Introduction

Financialization is a concept that encompasses a wide range of developmental and transformational aspects. According to Gerald Epstein's developments (Sawyer, 2014), "financialization involves the increasing influence of financial motives, financial markets, financial players, and financial institutions in the operation of domestic and international economies." It is a process in which financial intermediaries have gained advancements in financial transactions. According to Davis and Kim (2015), financialization refers to the increasing importance of finance, financial markets, and financial institutions in the workings of the economy (Davis & Kim, 2015).

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Fine (2012) stated that financialization is a terminology used to characterize some of the fundamental features of modern capitalism over the last three decades. Financialization, broadly defined, has "included the excessive expansion and multiplication of financial markets and their penetration into and influence over nearly every sphere of economic and social life" (Fine, 2012).

According to the Roosevelt Institute Report (2015), financialization refers to the growth of the financial sector, its increased power over the real economy, the explosion in the power of wealth, and the reduction of all of society to finance. Financialization is about the increasing control and influence of finance over the productive economy and traditional businesses.

E. Hein et al. (2016) argue that financialization has increased gross profit share and decreased labor income, raising wage disparities. It has forced business management to prioritize short-term financial advantages above long-term company growth. Financialization has increased debt- and wealth-financed consumption. Finally, the authors claim that opening international capital markets and capital accounts have created global and regional current account imbalances, even inside the EU zone (E. Hein et al., 2016).

During "financialization," the financial sector grew in size and sophistication. This impacted every type of business and household, and it had a significant impact on the economy and politics. In a short example, John Kay (2015) says that financialization took resources away from building new houses, businesses, or infrastructure but instead used them to trade securities linked to the existing companies or infrastructure (Kay, 2015).

From the above definitions, the gradual neoliberal process that gained momentum with increasing globalization - hence globalization of finance has become widespread within the last four decades, where finance and financial activities practically dominated the world markets with more power and more concentrated wealth, stealing roles and diverting resources from the real sector, and dwarfing non-financial profits can be taken as a brief description for the major characteristics of the globalization of finance and finance-led globalization.

How Does Financialization Begin?

While the origins of financialization can be traced back to the 1950s, the collapse of the Bretton Woods monetary system in the early 1970s spurred global liquidity expansion. It sparked a wave of financial liberalization and deregulation (Jubels, 2018). The Bretton Woods agreement tied international currencies to the US dollar and the US dollar to gold, providing predictability in currency rates and preventing speculative gains. The treaties were put in place to prevent the emergence of 'protectionism,' which had blighted the interwar years. It helped the United States, the

world's largest exporter, and its reserve currency (Jubels, 2018). As a result, the United States embarked on a spending spree to support the Cold War, particularly the Vietnam and Korean wars, and the Marshall Plan in Europe to assist post-war economies in purchasing US goods (Jubels, 2018). The US was producing more dollars and spending them elsewhere, so the volume of dollars in circulation far outweighed the US's. As concerns grew that the United States' substantial public debt was jeopardizing the fixed convertibility of dollars to gold, US President Richard Nixon unilaterally chose to cancel dollar-gold convertibility in 1971, thus ending the Bretton Woods agreements. Following a decade of deregulation of currency movements, the world transitioned to a new system of free commerce in products, floating exchange rates, and unfettered capital movement.

According to Blakeley and Jefferies (2020), the rentier class emerged with the industrial revolution, a freer flow of capital to where it could yield the highest return with laissez-faire policies. As a result of this, the bubbling of the US stock market until its crash in 1929, then the Great Depression, WW2, and the post-war conference Bretton Woods where the wild rentier economics was partially restrained thanks to policies suggested by Keynes, and the United States was assigned the role of the new world hegemon with the US dollar as the new world reserve currency (Blakeley & Jefferies, 2020). The current financial globalization phase started in the 1960s when London's Eurodollar market was set up. It prompted the process of economic globalization today. Moving money through London to get around Regulation Q in the US, which was meant to put a cap on the interest rates that banks could pay on deposit accounts to avoid the high-risk-taking behavior seen in the years before the Great Depression, caused many banks to fail. This allowed European and British banks to make money from their financial services. People don't need to use the term "Eurodollar" (Key Ravi Roy & Thomas D Wallet, 2019).

According to Kay (2015), the undermining of Regulation Q was a significant event that allowed globalization to apply pressure on national regulatory authorities, resulting in a transition from agency to trade. It shows the growing dominance of financial trading culture over more traditional agency-based customer servicing culture, which was more focused on personal relationships than current financial transactions, a large portion of which consists of computer-to-computer silent trading. According to Kay (2015), the breakdown of the Bretton Woods system, the creation of derivative securities, regulation and deregulation policies, the end of the Cold War era, and the rise of neoliberalism with Reagan in the United States and Thatcher in the United Kingdom all contributed to the financialization process.

The Emergence of Islamic Finance

Islamic finance has experienced substantial growth in the last 50 years as an alternative to the traditional, interest-based financial system. It has gained the

attention of the financial industry, as well as banking and capital markets. At the end of 2021, the industry will have assets worth \$3.37 trillion, and it has been growing steadily around the world (Farooq & Selim, 2019).

Overall, apart from its most important feature being riba-free (or interest-free, blanketly equating riba and interest), a key claim about Islamic banking and finance (IBF) is that, unlike its conventional counterpart, it focuses on the real economy (Farooq & Selim, 2019).

Islamic finance is built on plain and straightforward contracts based on standard, pure business transactions consisting of sale, lease, and sharing arrangements within genuine economic activities, which are valid for all societies. In other words, these contracts are practiced in every community and every legal system. Islamic finance has made these contracts in commercial laws of all societies throughout history the core and the heart of finance.

One of the vital principles of Islamic finance is the concept of Realism in all its transactions and contracts. In the Realism or Validity Principle, all financial arrangements must be founded on "actual" transactions or exchanges. In other words, Islamic finance produces value through the sale of commodities in return for delayed payments, the leasing of assets that provide utility over time, and the participation in business initiatives that generate value through innovation in the Schumpeterian sense. Consequently, Islamic finance is asset-based and forbids speculative transactions (Kahf, 2006).

In addition to this, as opined by Farooq and Selim (2019), asset linking can be of two types: asset-backed or asset-based financing. While most Islamic finance transactions are asset-backed, products such as Sukuk (the Shari'ah-compliant equivalent of bonds) are more sophisticated. In capital market operations, a Sukuk contract is categorized as asset-based if there are no designated assets to which Sukuk holders have recourse in the event of default and asset-backed if there are selected assets to which Sukuk holders have recourse in the event of default. The asset link distinguishes IBF transactions from conventional financial intermediation of loanable money.

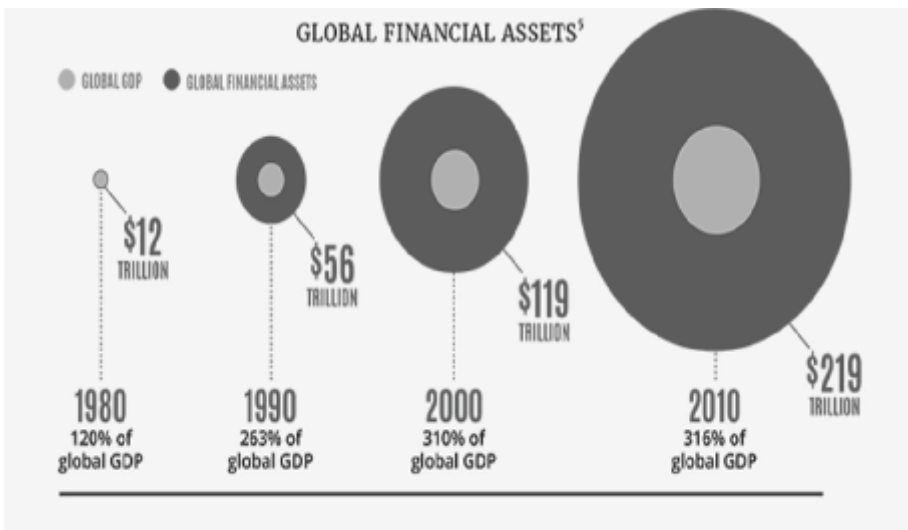
With the principles of Islamic finance, the main important point needs to discuss what could be the role of Islamic finance in the dilemma of financialization. Several scholars argue that Islamic Finance has excellent potential for a paradigm shift that would help and support the financial system avoid the disasters and crises we have faced in the past. This article will discuss the effects of financialization and its features. We will also discuss the role of Islamic finance in detail, which we can help overcome the impacts of financialization around the globe.

Literature Review

In different studies on financialization, several terms have been used to understand the concepts more clearly, such as financialization in terms of globalization, neoliberalism (ideas associated with the free market), capitalism, post-industrialism (marked by a transition from a manufacturing-based economy to a service-based economy), post-Fordism (the dominant system of economic production, consumption, and associated socio-economic phenomena in most industrialized countries since the late 20th century), activity-centered vs. accumulation-centered (Krippner's stated that the proposition for a new perspective is focusing on 'where profits are generated in the economy as opposed to the more classical approach of looking into different sectors' (e.g., services, information economy, etc.) contribution to GDP.

The growth of financial markets isn't just caused by the amount of money being traded. It's also caused by the widening range of transactions and market participants and how they interact with all parts of the economy and the rest of society. As Jubels (2017) states, financialization, in a nutshell, is a significant change in the way the financial sector works. It has changed everything from how families and businesses work to how monetary systems and commodity markets work. According to research, financialization has led to more inequality, less investment in "real" production, more demands on debt-ridden households and individuals, and less democratic accountability. So, look at the graph below: As we can see in the graph below (Jubels, 2017).

Figure 1: Global Financial Assets



Source: Transnational Institute – Amsterdam.

According to Krippner (2011), financialization refers to the growing importance of financial activities as a source of profits in the economy, distinguishing the dominance of the finance sector over all other industries. This includes the gradual change in operations of many traditional manufacturers who have turned to generating income through financial means rather than providing goods to their customers. In her main article on the Financialization of the US economy, Krippner (2005) gives a brief overview of different uses of the term financialization, including references to the increasing power of the rentier class within the society, the preeminence of maximizing the shareholder value principle among corporate management, the dominance of capital markets over bank-based finance, and the surge of financial trading with the help of new financial instruments and technology.

Lapavitsas (2013) points out a structural change in the capitalist system within the last four decades, identifiable in his middle-range theory as financialization. He describes the process of financialization through fundamental changes within the three main constituents of the capitalist system: the non-financial institutions, the banks, and the households. Lapavitsas argues that non-financial institutions, such as big manufacturing enterprises, since the late 1970s have been accumulating substantial amounts of capital through high retained earnings, which has enabled them to become more independent and less reliant on the banking sector for acquiring investment capital. Another facet of financialization for the non-financial sector, according to him, is that many of these firms are now providing and selling financial services in addition to their main activities, which is enhancing their earnings. In other words, a growing number of large non-financial corporations have become bank-like in terms of capital needs and earnings sources. Lapavitsas (2013) further believes that large banks have shifted away from traditional lending operations and into revenue streams such as financial market transactions and mortgages. Finally, he claims that more and more families are entering the financial markets, both in debt and asset purchasing. The average person has gotten more indebted and has a larger investment portfolio.

In the description provided by the Roosevelt Institute's report (Konczal, 2015) for financialization, a framework with four elements is offered: savings, power, wealth, and society. The report defines financialization as the growth of the financial sector, its increased control over the real economy, the explosion in the power of wealth, and the reduction of all of society to the realm of finance. It is claimed that finance has grown more profitable but less efficient over the last four decades, resulting in an economy that works only for fewer people by leaning towards inequality and insecurity.

Hein et al. (2016) argue that financialization has induced a rise in gross profit share and thus a decline in the percentage of labor income, increasing wage inequality. It has imposed short-termism on corporate management, implying preference by the executives for short-term high financial gains over real long-term growth of the firm.

Financialization has generated an increase in wealth-financed and debt-financed consumption. And lastly, the liberalization of international capital markets and capital accounts has allowed for increasing current account imbalances both at the global and the regional level, such as within the EU zone.

Hein et al. (2016) also argue that one of the milestones toward financialization took place in 1974 when the US Treasury decided to allow commercial banks instead of international bodies that were backed by governments such as the IMF or World Bank to recycle petrodollars from oil-rich countries and engage in lending to riskier countries, a practice that was forbidden by US law until then. Championed by Walker Wriston of Citi (later Citicorp or Citibank), the restricting law was overturned. Eventually, risky lending went bad for Citi and some other banks, and following the default in 1982, the Fed decided to bail the lenders out to stop a broader downturn.

According to Krippner (2011), deregulation of interest rate ceilings in 1980 was the author's last blow against Regulation Q. During the Reagan administration, the US deficit grew, fueled and maintained by foreign liquidity flooding into the country to take advantage of low-interest rates, which were kept high by the Fed (headed by Paul Volcker, known for his strict monetary policies) to combat rising inflation caused by deficit spending. Because of this, American enterprises and individuals became "the buyer of last resort" for global markets.

The US mechanism from the 1980s through the 2000s was as follows: Deficit expenditure by the US government. The Fed kept interest rates high initially to contain inflation and, after that, to stimulate capital inflows (Davis Exports & Kim, 2015; Konczal Mike, 2015). Because of the low-interest rates, the US currency strengthened. American consumers and businesses ate more foreign goods while growing their debt (through second mortgages, additional credit cards, etc.) as long as asset prices (on which the mortgages were drawn) rose. The flood of foreign money persisted due to low-interest rates and the US's size and willingness to consume many global exports. This long-term cycle reduced household savings in favor of rising debt and ushered in a new era of policymaking. Because money was just flooding in, the government could no longer rely on the domestic supply of credit as a primary policy instrument; instead, the price of credit became the critical criterion, and monetary policy became the dominating policy tool.

Globalization of Finance

Gerd Häusler, (2022) has led to interdependence across financial markets growing considerably in recent decades. There are many benefits to economic globalization for national economies and investors and savers, but there are also risks and problems for market players and governments.

Azkunaga Juan Antonio et al. (2013) argue that international financial markets rapidly integrate national financial markets, increasing economic ties and cross-border financial flows globally. Financial globalization has been the driving force behind the most significant changes in the previous three decades. Neoliberal economic reforms, deregulation, and financial liberalization defined this period. For financial institutions, this constitutes a significant shift from the business environment in which they operate. As a result, the corporate governance of financial institutions must adjust to the new climate. Breaking down this phenomenon into its many components can help you better understand and comprehend it. Neoliberalism, economic liberalization, and deregulation are the primary pillars of globalization.

Hein (2011) discusses a shift in the ambitions and restrictions of economic actors due to financialization and financial globalization. An accumulation regime's "financial driven" or "finance-dominated" features are the subject of an ongoing academic dispute. Finally, the effects of financialization on economic performance, income distribution, and long-term stability and predictability are examined, with increasing financial fragility due to growing debt levels characterizing the accumulation regime driven by finance, according to the author. However, the results have been substantially diverse in various nations because of continuing international imbalances.

There have been a lot of changes in the world's financial markets as a result of globalization and financialization (Abdulkarim et al., 2019). As we look at these changes, we highlight four that have significantly impacted how today's crisis has evolved.

Financial market imperfections have persisted, mostly related to information asymmetries between creditors and borrowers (Falkowski, 2011). These imperfections serve as the foundation for financial issues that have plagued the economy. Specifically, the financial contagion problem, uncertainty in financial decisions, and economic instability might be caused by increases in these asymmetries (Álvarez Peralta and Medialdea, 2010).

Globalization makes it possible to shift money from one area to another swiftly and cheaply since the financial sector has become globalized.

With the removal of the boundary between commercial and investment banking and the 1999 "Gramm-Leach-Bliley Act," conglomerates have developed, merging several financial operations inside a single organization (retail banking, investment banking, insurance, asset administration, investment funds, etc.) (Abdulkarim et al., 2019).

Institutional investors' relevance and influence have grown (Álvarez Peralta & Medialdea, 2010). In the banking sector specifically, financialization has had a

significant impact on the way companies operate internally, altering corporate governance and banking management structures.

Neoliberalism and Deregulation

Abdulkarim et al. (2019) describe neoliberalism as a new stage of capitalism that evolved after the structural crises of the 1970s, marked by the alliance of capitalist classes with top management, particularly financial managers, to strengthen global hegemony. It promotes private property rights, the rule of law, free markets, and free commerce. The state must safeguard economic freedom by enforcing its monopoly, according to this perspective.

Kotz (2010) adds that essential characteristics of a neoliberal state include private enterprise, entrepreneurial initiative, intellectual property, and poverty alleviation through free trade and free markets. Neoliberalism includes privatization, deregulation, reduced bureaucracy, lower taxes, increased competition among firms, and lower international trade barriers. Harvey contends that neoliberal thinkers are distrustful of democracy and prefer elite government. According to Fine (2013), neoliberalism is a reaction to a new global order promoting economic development, full employment, and welfare, with key institutions like the UN, World Bank, and IMF under US control. Keynesianism was accepted, and state ownership was promoted in particular businesses. Embedded liberalism, where political and economic organization style, was embedded in the liberal framework, whereas neoliberalism's principal objective is to disembed capital from any regulatory restrictions.

The embedded liberalism program worked well in the developed world throughout the 1950s and 1960s, but progress stalled in many third-world nations. The world order began to crumble at the end of the 1960s, leading to stagflation. Keynesian strategies failed to address these new concerns. The Bretton Woods system was destroyed, and currencies floated freely (Konczal Mike, 2015). The left proposed more state control, laws, and social democracy to combat the new crisis, but the experiments in many European nations failed to stimulate capital accumulation. So the neoliberal agenda of deregulation, privatization, and market liberalization triumphed, and a new era of policymaking gradually took hold.

What Happens Wrong in the Direction of Financialization?

The financial sector is much bigger than the Real Economy

As outlined in (Foster, 2008), financialization is defined as "the rise of the financial sector, the increase in its control over the real economy, the explosion of wealth power, and the subordination of society as a whole to the domain of finance. People believe that the financial sector, although making more money, has become

inefficient, leading to an economy that benefits fewer people while also increasing inequality and job instability. A roughly US\$ 95 trillion real sector in 2010 carried five times bigger derivatives market and around 25 times bigger foreign currency transactions market (Michailidou, 2016). There are two things that Michailidou (2016) looks at to show how emerging markets and financial crises are linked. They are high levels of financial flows from global finance centers into the emerging markets and financial market liberalization in emerging economies, both indicators of financialization. While noting some country-specific differences, she talks about how deregulated financial markets are subjected to volatile investment decisions, which drive asset prices up to unsustainable levels before even more high returns are expected on these assets (Palley, 2013). A lot of short-term debt fills up bank balance sheets because there is a lot of credit in the market. As a result, internal banking problems and an imbalance in the public sector cause a crisis. In her study on Mexico and Brazil, Michailidou (2016) found that when there is a lot of money in the financial market, it takes money from the real economy.

Table 1: Rise in the financial Sector

Global FX Turnover	Turnover hit \$6.6t in 2020 40 % Increase from last decade; it was \$3.2t Source: asianbankingandfinance.net
Global derivatives market	\$610 trillion by end-June 2021 \$559 trillion in end-December 2019 Source: BIS
Global equity capitalization/bond market size	Equity: \$125t 2021, the USA with \$ 52t around 42% of Global which was estimated \$ 95.0 trillion in 2019 Bonds: \$123.9 trillion in 2020 16 % increase which was estimated \$105.9 trillion in 2019 Source: SIFMA

Innovation-driven: Creation of complex and opaque financial instruments.

Global derivative trading has experienced significant growth (Omarova, 2012). In June 1998, the notional value of over-the-counter (OTC) derivatives exceeded \$72 trillion. Ten years later, in June 2008, it had surged to \$684 trillion, marking a nearly nine-fold increase. During this period, the notional value of derivatives traded on structured exchanges grew from \$2 trillion in 1990 to approximately \$14 trillion in 2000 and approached \$100 trillion in 2007. The total value of global contracts reached over \$20 trillion in June 2008 and expanded to \$32 trillion by year-end. In 2008,

interest rate derivatives surpassed commodities derivatives, credit default swaps, and foreign exchange derivatives in volume (Dumenil & Levy, 2011).

The Bank of International Settlements (BIS) recently estimated the global derivatives market at \$73 trillion in September 2020, with a predominant presence of short-term interest rate contracts. In the first half of 2020, the global OTC derivatives market was valued at approximately \$607 trillion, comprising \$94 trillion in foreign exchange contracts (including forwards, forex swaps, currency swaps, and options) and \$495 trillion in interest rate contracts (including forward rate agreements, swaps, and options). By 2020, the gross market value of all OTC derivatives was projected to reach approximately \$27 trillion.

Inefficiencies in Resource Allocation

Orhangazi (2008) conducted a regression analysis and discovered that financialization has adverse implications for real investment by non-financial firms, particularly large manufacturing companies. The author also asserts the robustness of these findings for non-manufacturing companies. These results provide support for the hypothesis that financialization exerts a negative impact on the accumulation of natural capital.

Batt and Appelbaum (2013) assert that an increasing number of businesses turn to strategies such as downsizing, outsourcing, or offshoring to enhance their stock prices, resulting in a net loss of employment. These cost-cutting measures on labor contribute to the development of a low-wage, low-benefit labor market with a growing share of employment for low-skill employees and a decreasing portion for relatively higher-skilled workers. The authors argue that this vertical disintegration of firms has a negative influence on income inequality.

In their study, Tomaskovic-Devey and Lin (2013) find a connection between financialization strategies in the productive economy and increased income inequality. These strategies boost executive income while simultaneously downsizing employees, impacting households negatively.

Financial Instability and Crises

Stockhammer (2010) emphasizes the substantial expansion of the shadow banking system, which has facilitated rapid innovation in financial instruments, primarily designed to circumvent regulations. This presents a significant challenge to proponents of unregulated markets who argue for superior risk management through enhanced securitization. The author also issues a warning against volatile capital inflows, which he perceives as potentially devastating for the market. Such inflows have the capacity to disrupt exchange rates and create opportunities for interest rate arbitrage.

Features of Financialization

People worldwide have been experiencing "financialization" for an extended period. While this phenomenon is inherently complex, certain common characteristics or features serve as indicators of this process, regardless of its origin.

The Dominance of Financial Trading

It is noteworthy that the role of banking has undergone a significant transformation in recent decades. In 2012, daily exports were close to \$60 billion, while daily foreign exchange trade averaged \$5.3 trillion. Traditional banking and finance fail to account for this nearly hundred-fold increase in trade volume. According to Dutta (2018), automated trading constitutes approximately 70% of activity in the US financial market and slightly less than 40% in Europe. Virtually all financial assets have experienced substantial growth in trading activity. As reported by Orhangazi (2008), the New York Stock Exchange traded 3 million shares daily in 1960, which escalated to 45 million shares in 1980, 200 million in the late 1980s, 800 million in 2000, and 1.6 billion shares in 2006. Moreover, the average daily trading volume in US Treasury debt securities surged from roughly \$96 billion in 1992 to \$500 billion in 2004 (Grahl & Lysandrou, 2006, as cited by Orhangazi, 2008).

Changing Nature of Market Relationships

Kay (2015) argues that the traditional norm in finance, characterized by agency principles founded on trust, safeguarded by legislation, and embraced by practical experience, gradually gave way to the concept of trade. Automated tasks like credit scoring supplanted the personal assessment of clients in financial institutions, resulting in the industry losing vital expertise and capabilities. Traders in interest rate futures were well-versed in derivatives but lacked understanding of political factors, while traders in mortgage-backed securities were knowledgeable about securities but lacked insight into housing or household requirements. As a consequence, the finance sector shifted away from the traditional role of intermediating based on economic needs and moved towards trading financial instruments.

Liquidity Need or Excessive Trading

According to Kay (2015), the increase in trade volume is often attributed to a lack of liquidity. However, the act of trading billions of dollars per millisecond, while acknowledging that price volatility is a prevalent feature in every market, suggests an artificial need created (or speculated upon) by the traders themselves. Liquidity in the market is primarily provided by speculators when they inject capital, and their transactions do not constitute the majority of market activity. Unfortunately, this was rarely the case.

Increased Share of Financial Profit in Nonfinancial Companies

Between 1950 and 2001, Krippner (2011) analyzed comprehensive data to illustrate the distribution of employment, GDP, and profits among the three major industry categories: manufacturing, FIRE (finance-insurance-real estate), and services. Over the last fifty years, the manufacturing industry's share of employment, GDP, and earnings has seen a significant decline, with the finance sector now dominating GDP and earnings.

Non-financial firms' financial portfolios primarily consist of interests, capital gains, and dividends, with claims increasing from approximately 24% in 1950 to over 70% in 2001. Capital gains appeared to peak at 40% in the 1960s and remained within the 20-25% range for the following decades. In contrast, dividends steadily decreased from around 50% in 1950 to less than 5% after the 1990s. Regarding financial portfolios, non-financial enterprises in the US have increasingly relied on interest income over dividends. Krippner also posits that the transfer of corporate finance functions from in-house to professional financial institutions might explain why the same firms generate more significant revenue from their economic activities. The author further discusses and dismisses the possibility that some American corporations may have moved production offshore and only benefited financially from overseas.

To support these findings and provide a broader economic perspective, Lapavitsas (2013) compared the financial assets held by non-financial enterprises in the US, Germany, Japan, and the UK. Between 1979 and 2007, non-financial corporations expanded their economic interests. Moreover, Lapavitsas notes that external money, including bank and market credit, has declined since the 1970s. Non-financial enterprises have become more self-sufficient, relying heavily on retained earnings. They show a preference for securities over bank credit to reduce their reliance on external funding. Although Germany and Japan heavily relied on bank-based financing, this trend held true for all four economies.

Inequality among the Social and Economic Sectors

In their study, Hein et al. (2016) enumerate several characteristics of Financialization, many of which can be considered symptoms or even ailments of this phenomenon. Empirical studies consistently demonstrate that Financialization amplifies income inequality by increasing the share of the top percentile while reducing that of labor, thereby widening the inequality gap. The pursuit of maximizing shareholder value principles encourages short-termism through practices such as performance-related bonuses, stock options, an exclusive focus on return on equity for rentiers, and the escalation of dividend payments and stock buybacks. These practices leave limited room for capital investments. Additionally, Financialization promotes consumption based on debt rather than an increase in household income, which, to some extent,

compensates for the lack of real wage growth. Easy access to credit is extended even to low-income earners, resulting in consumption growing at a faster rate than median income. Lastly, the liberalization of international capital markets has led to current account imbalances between national and regional entities, as seen in Europe, exacerbating exchange rate volatilities and speculative capital movements.

Stockhammer (2010) highlights the evolving behavior of households, as they increasingly rely on credit-financed consumption, sometimes at unsustainable levels. He questions the rational decision-making process of the average consumer, suggesting broader social and cultural consequences for society as a whole.

Corporations and individuals are all becoming more indebted

Debt has always been a fundamental element of the capitalist financial system, dating back millennia. As previously mentioned, concepts of money, debt, and credit have ancient roots, even evident in practices such as the use of bills of trade in ancient Babylon (Dünhaupt, 2014). Throughout history, many Muslim merchants engaged in credit-based transactions. However, it's important to recognize that the modern form of debt, particularly individual and household debt, is a more recent development and a hallmark of Financialization.

For a contemporary perspective, we can refer to the Global Debt Monitor from the July 2020 edition to obtain the latest global forecasts. In Q1 of 2020, as the worldwide COVID-19 pandemic was just beginning with less than a million cases, the international debt-to-GDP ratio reached a new high at 331 percent, equivalent to \$258 trillion. Established countries held global debt amounting to \$185 trillion (392 percent of their respective aggregate GDP), while developing markets accounted for \$73 trillion (230 percent of their respective aggregate GDP). This global debt was distributed among various sectors: consumers held \$48 trillion, non-financial firms had \$76 trillion, governments owed \$70 trillion, and the financial sector was responsible for \$64 trillion.

It's notable that after 1960, the total claims on all central governments (loans extended to central government institutions net of deposits) never exceeded 25% of global GDP (Chen et al., 2019). This percentage decreased to below 15% just before the Global Financial Crisis (GFC) in the 1990s. However, net sovereign claims surged significantly after the 2008 crisis, surpassing 33% of global GDP by 2019. The changes in sovereign debt levels varied from country to country, with the US, China, India, and the UK witnessing increases in their net debt ratios (from around 18% in 2008 to 42% in 2019), while Germany experienced a decrease from 9% (as a net creditor) in 2008 to 9% (as a net debtor) in 2019. It's worth noting that the Japanese Central Bank accumulated public debt equal to approximately 145 percent of its GDP, amounting to roughly 11 trillion dollars, surpassing even the debt levels of a de facto defaulted Greece.

As Kay (2015) highlights, despite the fact that the actual increase in median household income in the US has been less than 5 percent since 1973, the total credit volume extended to consumers has grown significantly and disproportionately. Individuals often borrowed against the anticipated appreciation of their real estate, and those who were previously ineligible for housing were made eligible for the sake of credit expansion. Consequently, consumers began consuming more than their earned income, leading to an unsustainable cycle that came to a halt (or perhaps an end) with the onset of the Global Financial Crisis in 2008.

Increased Role of Finance in Corporate Governance

As described by Ireland (2012), the emergence of the joint-stock company in the early 20th century in the United States marked a significant transformation from a product market-dominant money economy to a capital market-dominant credit economy. This shift redirected the focus of enterprises from strategies aimed at enhancing long-term productivity to methods of generating short-term financial gains. The depersonalization of business, characterized by the replacement of traditional corporate shareholders with "anonymous pensioners," became more widespread in various economies worldwide, largely driven by the corporate revolution. Ireland, referencing Keynes, highlights the potential conflict between the societal interest and that of businesses, stating that "there is no clear evidence from experience that the investment policy which is socially advantageous coincides with that which is most profitable."

Following the 1920s, the pro-finance stance within the business world diminished, and managerial theories gained prominence. However, there was a resurgence of finance and the ascent of the shareholder value corporation in the 1970s. Ireland points out a significant distinction between finance capitalism in the 20th century and the new finance capitalism in the early 21st century. The former relied on financiers and investment bank representatives sitting on corporate boards, while the latter utilized stock markets for indirect control of businesses. This indirect and remote control of corporations by the finance sector, executed with discipline in the Anglo-American world, proved effective when compared to the more direct control by financial entities observed in countries like Germany. Nevertheless, it's worth noting that the concentrated approach of doing business with a closer relationship to financial stakeholders and committed capital, although criticized for potentially infringing on minority shareholders' rights, is also considered more conducive to industry and welfare due to its longer-term investment perspective.

Admati (2017), in a study on Financialization in corporate governance, indicates that only 16 percent of all CEOs in S&P 500 firms received compensation based on their performance before the 1970s. This ratio increased to 26 percent in the 1980s and further rose to 47 percent in the 1990s. Traditionally, the primary performance

criterion for executives in developed economies such as the US or the UK has been maximizing shareholder value, assessed through metrics like stock prices, earnings per share, return on equity, and similar ratios. This tendency to set financial goals for management, initially aimed at aligning the interests of shareholders and managers, played a significant role in the Financialization of corporate governance.

Furthermore, as cited by Gilson and Gordon (2013), institutional investors in 2009 held approximately 73 percent of corporate ownership among the largest thousand corporations in the US, a significant increase from about 6 percent in the 1950s. This shift complicates ownership structures since institutional investors are less likely to be directly concerned with individual investor benefits. Instead of affluent individuals owning stock or holding positions on the board, entities like mutual funds, pension funds, hedge funds, or even subsidiaries of other firms act as shareholders in the company. The presence of so-called shell corporations further complicates the classic principal-agency relationship between shareholders and business management, as these entities are legal structures with no staff, no public shares, and often only a postal address.

The way towards the Reforms; Financial Structure changes

The current financial system is inherently unstable, necessitating reform to address its existing flaws. In the 1980s, reform efforts took the form of liberalization, marking a significant shift in the market dynamics. However, following the global financial crisis of 2008, efforts were made to regulate and legislate the financial market. Regrettably, aside from a few minor adjustments, little substantial change has occurred within the financial market. Prior to the 2008 crisis, the estimated value of financial options stood at 600 trillion dollars, and post-crisis, this value was projected to reach 1200 trillion dollars (Chiapello & Knoll, 2020). Despite these developments, the virtual structure of finance has remained largely unchanged since regulatory measures lacked the vision or capacity to transcend borders. This persistence is attributed to a fundamental misperception where finance's support and service function have been confused with its wealth generation function.

Finance's primary mission is to facilitate production and exchange, a role outlined by Chiapello and Knoll (2020). However, the financial sector and institutions have been assigned an erroneous role in the context of Financialization, leading to a misallocation of resources that diverts wealth growth into wealth transfer. While wealth transfer is indeed feasible, it does not create new wealth or value, thus transforming finance into a realm of speculative gambling through virtual transactions.

To implement the necessary changes in how finance operates, a return to the fundamentals is essential. Finance should serve as a tool to support the real economy, necessitating a shift away from speculation and the virtual finance environment.

Moreover, there should be a move away from interest-based debt, which tends to impede wealth-building activities. Once these changes are in place, financial institutions within the finance sector can contribute to wealth generation by aiding individuals in making the most of the additional resources generated from their participation in the real world. The ultimate goal is to reorient the finance sector towards supporting the real economy by redirecting money and resources from speculative ventures and virtual contracts to productive sectors (Farooq & Selim, 2019). In this context, it is crucial to explore fundamental principles of Islamic Finance as part of the reform agenda for addressing the challenges posed by Financialization.

Concept of Realism

Realism is deeply embedded in the fundamental principles of Islamic economics and business law, offering a pragmatic and adaptable approach that blends private and public ownership, reflecting real-life dynamics devoid of the dogmatism associated with capitalism and communism. In the realm of Islamic finance, realism stands as a foundational and conceptual principle. Islamic finance is rooted in real assets and transactions, eschewing hypothetical or artificial constructs. It embraces and legitimizes financial instruments that represent tangible, real-world assets (Kahf & Mohamed, 2016).

In contrast, the conventional financial market is characterized by a plethora of financial instruments that often lack this grounding in real assets. For instance, the market is flooded with share options, commodities, and currency options that far outnumber the actual shares, commodities, or currencies available for trading on exchange markets. To illustrate this disparity, consider a firm with a total market capitalization value of 10 billion dollars; you may find options on its shares with a market value of 200 billion dollars. Astonishingly, before the 2008 financial crisis, the market value of options exceeded the entire global GDP by a factor of three (Kahf, 2013).

Furthermore, many financial contracts in today's financial sector deviate from the realism concept. For instance, transferable pollution permits, as seen in the Kyoto 1997 Protocol, allow corporations to buy and sell permits to harm the environment by releasing CO₂. These permits essentially represent the right to cause environmental harm without any benefit to the environment or society. Similarly, options and other derivatives, which are traded in financial markets, do not reflect real assets but rather speculative instruments for transferring wealth without adding tangible value (Farooq & Selim, 2019).

The prevalence of these financial instruments and practices highlights the departure from realism in the financial sector. In Islamic finance, a financial asset must genuinely represent a tangible asset, while financial instruments that do not are

considered fictitious. Interest, or Riba, is another aspect where realism is upheld, as it recognizes that the advantage or added value generated by an asset rightfully belongs to its owner. In Islamic finance, interest is prohibited because it grants the borrower full ownership of the loaned funds and any increase derived from them, without entitlement for the lender.

Even the sale of debt is scrutinized through the lens of realism. Debt selling merely replaces creditors and debtors without creating wealth, as debt is an abstract concept that inherently does not generate incremental value. Realism in Islamic finance emphasizes that entitlement to an increase can only exist when the underlying asset adds genuine value. If the asset does not appreciate in value, no entitlement to an increment arises.

In summary, realism in Islamic finance accommodates market-based funding and reduces the scale of actual market transactions, aligning the finance sector with the size of genuine, real-world transactions (Beckman, 2017).

Earning by Owning

In Islamic finance, the primary avenue to generate income is through ownership of real assets that contribute to value increment or increase. Ownership of an asset that adds value justifies acquiring the additional property or value generated by that asset (Kahf & Mohamed, 2016). Therefore, to earn money in finance, one must initially possess a tangible asset that meets specific criteria rooted in the structure of assets. An asset is considered suitable for financing if it has the capacity to generate increments, benefits, or at least material wealth. It must add genuine value to qualify as an asset, and any item that fails to produce increments or benefits is not deemed suitable for financing. In other words, a financial claim cannot be substantiated if the item it is based on does not add value. In Islamic finance, an asset that is detrimental or harmful is not even recognized as an asset.

Contrary to conventional capitalism, where risk trading is a common strategy to gain income, Islamic finance approaches risk differently due to ethical concerns, potential for unequal trade, and the potential for unfavorable outcomes. For example, in the case of Kafalah (Guarantee), when you provide a debtor with a pure risk without owning any property, you may be held liable if the guarantee is invalidated. However, because Kafalah represents a pure risk transaction that does not add value, earning from it is prohibited in Islamic finance. Guaranteeing a debtor does not involve actual ownership of an asset, and this contractual activity does not create genuine value.

Earning in Islamic finance is firmly centered on ownership. Ownership of assets carries inherent risks, as these assets may experience various hazards such as damage, loss, depreciation, or obsolescence. Risks can manifest as assets breaking, disappearing, losing value, or becoming less useful to the owner due to factors like

changing consumer preferences, natural wear and tear, technological advancements, or shifts in market demand (Kahf, 2022). Property owners are entitled to any increase in value their assets generate, but they are also exclusively liable for any loss, damage, liability, or decline in value. Risk is considered a feature rather than a cause of entitlement in Islamic finance.

However, in today's conventional finance sector, tools like futures, derivatives, short sales, and difference contracts enable individuals to earn income without necessarily owning an underlying asset. These transactions, as exemplified by the 2008 global financial crisis, have at times distorted market discipline and contributed to the formation of financial bubbles.

Moral Commitment

In today's financial system, there is often a lack of significant ethical or moral principles guiding financial practices. The primary objective is to generate profits by utilizing complex financial instruments while adhering to existing laws and regulations. This pursuit of financial gain without due consideration for ethics or morals was one of the leading causes of the 2008 global financial crisis. Islamic finance, on the other hand, incorporates ethical and moral principles into its financial contracts, drawing from the moral, honest, and legal principles of Islam (Kahf, 2005). Moral obligation is a fundamental aspect of Islamic law, and it extends to all sectors, including Islamic finance contracts. Islamic finance contracts are designed to embody moral commitment in two essential ways.

Firstly, Islamic finance contracts take into account the properties of the assets involved. The assets, goods, and services contracted in Islamic finance transactions must not cause harm to people, property, or the environment. Islam prohibits the purchase and sale of commodities that are scientifically established to be harmful, and such commodities are considered unlawful. For instance, Islamic banking strictly prohibits financing products like alcohol and cigarettes, which are known to be detrimental. These harmful assets, which are against the principles of the Shari'ah, hold no genuine value and must be avoided in Islamic finance. Therefore, funding assets that pose harm to individuals or the environment is forbidden in Islamic finance, aligning with its ethical principles.

Second Layer of Reform needed under the Islamic Finance Principles

Islamic finance is distinct in its reliance on fundamental and straightforward contracts that are rooted in everyday commercial transactions. These contracts encompass common economic activities such as sales, leases, and sharing agreements, which are universally accepted across civilizations and legal systems. Islamic finance elevates these fundamental contracts, which have historically existed in the business laws of various regions, to a central and essential role within the financial industry. The

principles borrowed from Islamic finance offer a potential path for rectifying finance and the functions of financial intermediaries within the broader economy. These principles provide a framework for restoring ethical and sustainable practices to the financial sector.

Re-Channel Finance Through Sale, Lease, and Venture Capital Provision

Only contracts based on selling, leasing, or sharing money should be used to obtain funds, not loans. Transactions involving credit sales or advance payments should be employed by individuals and businesses to secure finances. These funds are derived from genuine transactions in an actual market, and any credit should be intricately linked to these transactions (Must, 2017). Funding should exclusively support the initiation of new enterprises and the enhancement of existing ones. By utilizing sales, leasing, and sharing avenues, one can connect credit with the real-world requirements, thereby bridging the gap between finance and the tangible world. It is essential for every financial transaction to align with this principle to be considered genuine.

In lieu of interbank debit transactions, banks should opt for collaborative agreements. A crucial responsibility of banks is to ensure they maintain adequate liquidity to meet customer loan demands, cash withdrawals, and seize profitable opportunities. Liquidity is especially critical for the effective functioning of banks, and central banks exert substantial influence over the available money supply. If interbank debit transactions are not preferred as a means of managing funds, alternative agreements between banks, such as the Musharakah and Mudarabah lines of credit, can be considered. The Murabahah line of credit, for instance, is an interbank contract that permits a larger bank or central bank to extend credit facilities to an Islamic bank through a sequence of Murabahah financings. This enables the Islamic bank to utilize the Murabahah line of credit master agreement to procure goods for its customers based on the Murabahah principle from the larger bank or central bank (Kahf, 2015, p. 392). Both Mudarabah and Musharakah lines of credit, as well as certain types of securitization, such as lease contracts, revolve around tangible assets, goods, and services that can be sold or leased to third parties. It is imperative for Islamic banks to abstain from engaging in debt trading within the interbank market to acquire funds, whether these transactions occur between banks or between banks and central banks.

Elimination of debt trading and keep holding on to debts that you create

In debt trading, any claimed increment is false because transferring a debt from one person to another does not create added wealth. Accordingly, debt trading is ruled out completely, which implies that you will have to face all its consequences if you create debt, as you cannot pass it to other economic units. Therefore, you must be more cautious that created debts shall be collected on their due maturity.

Removal of non-real value-adding financial transactions

Non-real-added-value financial transactions become irrelevant in the Islamic financial system. Such trades are created and introduced throughout the capitalist financial markets to make quick financial gains for one party at the expense of other parties involved, including zero-sum transactions such as gambling and speculative behaviors like day trading (Kahf, 2022).

Zero-sum and other speculative contracts, such as the short-selling of commodities, stocks, and currencies that do not provide any new value and merely transfer wealth from losers to winners, are parasitic on the real sector by design. Resources that could be utilized in the real market are diverted to the shadow market, resulting in a distorted allocation of resources. In contracts for the Difference (CFD), such as Tawarruq or Baay' al 'Inah, no products are exchanged; only cash is exchanged.

There is no sale of risk, and trading instruments that create risk are absent. The famous statement "No risk, no gain" cannot be upheld as an exclusive principle of Islamic finance because the devil is always in the details. While property risk is always a characteristic of property ownership, risk alone is not a tradable commodity or a factor contributing to the value of output. It is not the reason, cause, or generator of return or added value. Return or gain is generated by the property and expressed and deserved through entitlement rights, which, like property risk, are inherently attached to property ownership. Only the risk of ownership is relevant to entitlement to increments because it is the only risk that is necessarily intrinsic to ownership.

Elimination of All Derivatives

CDOs (Collateralized Debt Obligations) and CDS (Credit Default Swaps) were the leading causes of the 2008 global financial crisis. We need to gradually eliminate credit and insurance derivatives, and then all derivatives in general. This includes the following:

Stop option trading: Options are defined as "capital market instruments that give the holder the right, but not the obligation, to buy or sell an underlying asset at a specified price on or before a predetermined date."

Developmental and Productive approach

Investing in real-world sectors, such as small and medium-sized enterprises (SMEs), infrastructure, technology, manufacturing, various industries, agriculture, and healthcare, has a significant impact on job creation, technological advancement, clean energy, and environmental improvement. All of these aspects contribute to developmental progress by definition. Simultaneously, abstaining from financing harmful services and products, such as pornography and tobacco, enables the community to channel its energy and resources toward developmental endeavors.

Genuine Organized Market

The markets for stocks, commodities, and currencies need to be genuine to facilitate trading. To ensure the authenticity of transactions, specific rules must be introduced. For instance, margins should be reduced to minimize leverage, requiring that all transactions be fully paid when executed. Consequently, real transactions will predominate in financial markets, displacing virtual transactions (Watkins, 2017).

Commodity futures should exclusively serve the purpose of safeguarding real market positions. They are invaluable for hedging but should not be utilized for speculative trading. Therefore, commodity futures should only be accessible to individuals involved in the production or utilization of the underlying goods. In essence, only genuine producers and users of goods should engage in future contracts that culminate in actual deliveries of the goods. To enforce this, a licensing or registration system can be established for commodities within the market.

Similarly, the use of currency futures contracts should be restricted to hedging real-world trades. This necessitates the implementation of regulations in the financial market to specify who can engage in buying or selling currencies. This approach will bring authenticity to the market, ensuring the participation of genuine individuals while deterring those who merely engage in speculative trading or "clicking on computer buttons" and acting as "renters".

Inclusiveness

Kahf (2022), underscores the importance of fostering financial inclusion as a fundamental aspect of economic development in every society. In the context of Islam, the circulation of wealth is highly esteemed as a noble objective. Unlike the conventional financial system, which primarily focuses on risk transfer, the concept of inclusiveness in Islamic banking centers on risk-sharing rather than risk transmission. Furthermore, Islamic redistributive instruments such as Waqf, Zakah, and Qard-Hassan enable affluent members of society to support the most vulnerable community members (Askari et al., 2012). This perspective also extends to corporate inclusiveness, wherein larger and more powerful companies and entities aid smaller and more vulnerable ones in their survival and growth.

Conclusion

The process of financialization is observed to be reshaping capitalism into what can be termed financial capitalism. This form of capitalism sees financial intermediaries receding into the background, while other financial processes take precedence as the primary sources of wealth and profit accumulation for both financial institutions and industrial corporations. Profit maximization through trading books or investment operations has come to supersede financial intermediation, often referred to as

banking book activities, within financial institutions. Notably, activities like currency trading, trading in financial assets such as bonds and derivatives, as well as the packaging of financial products and claims like mortgage-backed securities (MBS) and collateralized debt obligations (CDO), have emerged as the primary activities and profit sources for banks, the traditional financial institutions. A parallel transformation has occurred within industrial institutions, where finance and the trading of financial claims have become the primary sources of their net profits.

The economic consequences of this trend towards financialization within capitalism have manifested in periodic financial crises and economic depressions. On the social front, it has led to wealth concentration, increased income and wealth inequality within societies, wider economic disparities between nations, the rise of financial oligarchies, and societal unrest and disruptions. Studies of financial and economic crises have identified specific causes for these downturns, often stemming from deviations away from the true path of production and exchange, pulling economic activities into areas that do not generate real added value, despite appearing to create wealth through wealth transfer. Consequently, there is a need to explore the relationship between structural and paradigm shift changes and the concepts of Realism and asset ownership. Islamic Financial Institutions can potentially play a pivotal role in addressing these challenges by developing products based on the principles of lease-sale and capital sharing. It is imperative that all financial sector institutions, including those involved in finance provision and financial intermediation, adopt principles of good governance, earning through the ownership of value-creating properties, engaging in real market transactions, and incorporating ethical commitments (Kahf, 2022).

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