Econosains 19 (2)(2021) E-ISSN: 2252-8490
ECONOSAINS
http://journal.unj.ac.id/unj/index.php/econosains/

# The Islamic Financial Literacy: A Theoretical View

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**Abstract**

This study aims to define a conceptual view of the Islamic financial literacy. This paper elaborates some scholars, which have explored financial literacy based on various dimensions to develop the concept of Islamic financial literacy. Based on previous literature, this study evolved the definition of Islamic financial literacy as the ability of individual to understand knowledge about the Islamic principles and Islamic contracts in financial decisions making to achieve one's financial well-being.

**Keywords**: Islamic Contracts; Islamic Financial Literacy; Islamic Principles

Received: May 19th, 2021
Accepted: July 26th , 2021
Publish: August 1st , 2021

**How to Cite:** . Widyastuti, Umi. *The Islamic Financial Literacy: A Theoretical View.* Econosains, 20 (2), P

## INTRODUCTION

In recent years, financial literacy is still become an interesting topic to be explored, along with the development of financial markets and technology. People are required to be able to make financial decisions based on the information they have. The low financial literacy will lead someone to make some mistakes in financial decision making. The low level of financial literacy is not only occurred in developing countries, it even spreads in many countries that have good financial markets, such as Germany, Netherlands, Sweden, Italy, Japan, and New Zealand (Lusardi & Mitchell, 2011).

The concept of financial literacy is often associated with some different terms. Zait and Bertea explained that the terms of financial capability, financial literacy, financial knowledge, financial education, and financial competence are interchangeable (Zait & Bertea, 2015), but some scholars define each of these concepts differently. The concept of financial education discussed by Huston (2010) as a process which is intended to increase one's human capital, especially financial knowledge and its application. Based on this literature, it was described as the difference between financial literacy and financial education. While financial competence is intended to explain the knowledge and behaviour that contribute to financial capabilities. Each concept is interrelated, but it could not replace one by another.

Some scholars have revealed a different point of view in defining and measuring financial literacy (Huston, 2010; Knoll & Houts, 2012; Remund, 2010), so the topic of financial literacy still offer some research gap to be filled. Nevertheless, along with the development of the Islamic financial industry, the literature which define Islamic financial literacy are still very limited (R. Abdullah & Razak, 2015). Therefore, this study will develop the concept of Islamic financial literacy by elaborating some literature about financial literacy.

## LITERATURE REVIEW

The concept of financial literacy remains many challenges to be observed including how financial literacy is defined and to be measured (Knoll & Houts, 2012). Therefore, Huston (2010) conducted a meta-analysis from several studies on financial literacy, which aims to identify how previous research defines financial literacy and develops standardized the measurement methods. It is known that forty-seven percent of those research stated that financial literacy had the same meaning as financial knowledge. It was also supported by Sabri (2011) who emphasized that the term of financial knowledge is often used to replace financial literacy. Instead Hung, Parker, and Yoong (2009) stated that financial knowledge is a form of financial literacy.

Arguing that financial literacy is often interpreted as financial knowledge, Huston (2010) also asserted that two of the eight scholars which are compared, define financial literacy as financial capability, while the other three studies define financial literacy as financial knowledge and financial capability that could be lead someone to achieve financial welfare or financial security as their desired outcome. And there was one study that defined financial literacy as financial knowledge, without explaining the outcomes they expected.

The most basic and common definition used in some scholars is knowledge (or understanding). Some studies measured financial literacy which is assumed as knowledge about finance (Chen & Volpe, 1998; Floyd, 2015; Hogarth & Hilgert, 2002; Hung et al., 2009; Knoll & Houts, 2012; Tharayil, 2015). This was also expressed by Fernandes, Lynch Jr, and Netemeyer (2014) that most studies on financial literacy emphasized more on objective knowledge. Although conceptually, financial literacy should measure the skills in managing finances.

In contrast to the definition of financial literacy described above, the President's Advisory Council on Financial Literacy (PACFL) defined financial literacy as the ability to use knowledge and skills to effectively manage financial resources to achieve financial prosperity for life (Hung et al., 2009). The definition proposed by PACFL is an understanding recognized by three financial literacy institutions, namely Jump$tart Coalition, PACFL, and Financial Literacy and Education Commission (FLEC). Therefore, Floyd (2015) used this definition in his study. In that sense includes two things that need to be underlined, namely the ability to apply the knowledge and the skills in managing their finance in a state that is constantly changing (Widdowson & Hailwood, 2007).

Table 1 presents the conceptual definition of financial literacy from various scholars. Referring to table 1, most of the literature defined financial literacy as the ability to use financial knowledge. However, some scholars defined financial literacy as one's knowledge of basic financial concepts, especially those that applied a conventional principles.

**Table 1. Definition of Financial Literacy**

| No | Sources | Definition of Financial Literacy |
|---|---|---|
| 1. | PACFL (Hung et al., 2009) | *"the ability to use knowledge and skills to manage financial resources effectively for a lifetime of financial well-being."* |
| 2. | Jump$tart Coalition (Hung et al., 2009) | *"the ability to use knowledge and skills to manage financial resources effectively for a lifetime of financial well-being"* |
| 3. | M. A. Abdullah and Chong (2014) | *"the ability to make effective decisions regarding the use and management of money and other assets."* |
| 4. | Remund (2010) | *"a measure of the degree to which one understands key financial concepts and possesses the ability and confidence to manage personal finances through appropriate short-term decision-making and sound, long-range financial planning, while mindful of life events and changing economic conditions."* |
| 5. | Huston (2010) | *"measuring how well an individual can understand and use personal finance-related information."* |
| 6. | Bhabha, Khan, Qureshi, Naeem, and Khan (2014) | *"a mishmash of awareness, knowledge, skill, attitude, and behavior essential to make sound financial decisions and also finally achieve individual financial wellbeing."* |
| 7. | Lusardi (2008) | *"Knowledge of basic financial concepts, such as the working of interest compounding, the difference between nominal and real values, and the basics of risk diversification"* |

| No | Sources | Definition of Financial Literacy |
|---|---|---|
| 8. | Aren and Aydemir (2015) | *"the degree to which an individual knows about the fundamental financial concepts and the functioning of the financial markets."* |
| 9. | Chen and Volpe (1998) | *"Ability to read, analyze, manage and communicate about the personal financial conditions that affect material wellbeing."* |
| 10. | Lusardi and Mitchell (2014) | *"Peoples' ability to process economic information and make informed decisions about financial planning, wealth accumulation, debt, and pensions."* |

Reversely, there is lack of study which explore Islamic financial literacy. Therefore, this study will develops the construct of Islamic financial literacy by underpinning to the previous studies which explain the definition of financial literacy and a few study about Islamic financial literacy.

According to M. A. Abdullah and Chong (2014), Islamic financial knowledge is a collection of knowledge obtained specifically related to the concepts and products of Islamic finance. As explained before, financial literacy did not have the same meaning as financial knowledge. R. Abdullah and Razak (2015) explained that the definition of Islamic financial literacy could be developed by referring to the definition of financial literacy by including elements that are following Islamic principles.

**Table 2. Definition of Islamic Financial Literacy**

| No | Sources | Definition of Islamic Financial Literacy |
|---|---|---|
| 1. | M. A. Abdullah, Ab Wahab, Sabar, and Abu (2017) | *"Islamic financial literacy can be defined as the ability to understand finance based on sharia compliance."* |
| 2. | Rahim, Rashid, and Hamed (2016) | *"The ability of a person to use financial knowledge, skill, and attitude in managing financial resources according to the Islamic teachings."* |

Therefore M. A. Abdullah et al. (2017) explained the Islamic Financial Literacy as a person's ability to understand financial concept based on Sharia principles. Meanwhile Rahim et al. (2016) adopted the concept which is developed by the OECD. They defined Sharia financial literacy as a person's ability to use their knowledge, skills and financial attitudes in managing their financial resources according to Islamic principals.

After discussing about the definition of financial literacy, we know that there were several definitions of financial literacy which were assume as financial knowledge. Referring to the several studies presented in table 3, the first dimension used to measure financial literacy is financial knowledge both subjective and objective (Henager & Cude, 2016). It could be seen based on the definitions according to Bhabha et al. (2014), Lusardi and Mitchell (2008). However, Nicolini, Cude, and Chatterjee (2013) stated that the measurement of financial literacy whether it should use financial knowledge comprehensively or specifically. Hung et al. (2009) emphasized that it is necessary to consider using financial knowledge specifically to measure financial literacy. In this way, the results of the research will be more beneficial.

Alleyne and Broome (2011), Aren and Aydemir (2015) and Van Rooij, Lusardi, and Alessie (2011) measure financial literacy using the dimensions of basic and advanced or sophisticated financial literacy (Lusardi & Mitchell, 2007a). Basic financial literacy measures individual awareness about basic topics in finance such as numeracy, compound interest, time value of money, inflation and money illusion. Meanwhile, advanced financial literacy is intended to measure operating activities on the financial market, the difference between bonds and stocks, how to diversify risk and the relationship between bond prices and interest rates.

In contrast, Abdallah and Hilu used the ability of fundamental analysis and technical analysis to measure financial literacy (Abdallah & Hilu, 2015). Likewise, Jonsson, Söderberg, and Wilhelmsson put more emphasis on technical financial knowledge (e.g. the ability to calculate compound interest) in measuring financial literacy in mutual funds investments (Jonsson, Söderberg, & Wilhelmsson, 2017).

Also, Remund (2010) conducted a literature review from various studies since 2000 and found that the conceptual definition of financial literacy can be categorized into five groups namely (1) knowledge of financial concepts, (2) the ability to communicate financial concepts, (3) intelligence in managing personal finances, 4) skills in making financial decisions, and (5) confident in making effective, (6) knowledge of financial concepts and products (financial knowledge variables), (7) the ability to use knowledge to make decisions (financial ability variables, (8) real use of different financial instruments (financial behavior variables), (9) a person's confidence in previous financial decisions and actions (financial confidence).

On the other hand, Widdowson and Hailwood (2007) describes the elements contained in the definition of financial literacy including (1) basic mathematical skills, (2) an understanding of the benefits and risks associated with certain financial decisions, (3) the ability to understand basic financial concepts, including trade-offs between risk and rate of return, the main features of investment instruments and financial products, the benefits of diversification, and the time value of money, and (4) capacity to seek financial advisors and know what to ask, the ability to understand the advice given by financial advisers. Referring to those results, Table 3 explains the dimensions of financial literacy used in various studies:

**Table 3. The Dimension of Financial Literacy**

| No | Dimension | Sources |
|---|---|---|
| 1. | Financial knowledge | Chen & Volpe (Chen & Volpe, 1998), Floyd (Floyd, 2015), Hogarth & Hilgert (Hogarth & Hilgert, 2002), Hung et al.(Hung et al., 2009) , Knoll & Houts (Knoll & Houts, 2012), Lusardi (Lusardi, 2008), Tharayil (Tharayil, 2015). |
| 2. | Objective financial knowledge | Henager and Cude (2016) |

| No | Dimension | Sources |
|---|---|---|
| 3. | Objective financial literacy | Sivaramakrishnan, Srivastava, and Rastogi (2017) |
| 4. | Ability to use knowledge | PACFL, Jump$tart Coalition, M. A. Abdullah and Chong (2014), Remund (2010) |
| 5. | Subjective financial knowledge | Henager and Cude (2016) |
| 6. | Subjective financial literacy | Sivaramakrishnan et al. (2017) |
| 7. | Sophisticated financial literacy | Lusardi and Mitchell (2007a) |
| 8. | Understanding-Personal finance knowledge<br>Use-Personal Finance Application | Huston (2010) |
| 9. | Fundamental and technical analysis | Abdallah and Hilu (2015) |

Beside the dimension of financial literacy which is mentioned above, there have been many studies aimed at developing instrument in measuring the level of financial literacy, including Hung et al. (2009), Floyd (2015), Knoll and Houts (2012). However, Huston (2010) asserted that until now there was no standard instrument in measuring financial literacy. Most research on financial literacy refers to the Jump$tart Coalition instrument which is developed in 1995 (Floyd, 2015).

Some literature also show that there were no standard on how to measure financial literacy. Knoll and Houts (2012) identified various ways of measuring financial literacy in previous research based on the topic, content, and type of measurement. It is known that the topics taken in the measurement of financial literacy include interest, inflation, time value of money, investing, risk diversification, debt management, housing, savings for retirement, life insurance, and annuities. Besides the different topics, the type of measurement show that some research used true or false statements for the instrument, and some others used multiple choice on the answer, while another study used the likert scale in the measurement.

The measurement of financial literacy are carried out by examining aspects of basic knowledge about interest rates, inflation and risk diversification (Lusardi, Mitchell, & Curto, 2009). Meanwhile, Chatterjee, Fan, Jacobs, and Haas (2017) measure financial literacy by using statements with true or false questions that reflect the knowledge about interest rates, inflation, bonds, mortgages, and stocks. If the answer is correct, it was coded by 1. While the answer is false, it was given code 0. Besides, Danes and Hira (1987) also conducted a study who measured student's knowledge about credit cards, insurance, personal loans, recording transactions, and overall financial management. Whereas Allgood and Walstad (2016) observed the concept of financial literacy on credit cards, investments, loans, insurance, and financial advisers.

In line with Remund, Alhenawi (2013) described the operational definition of financial literacy as specific financial knowledge about budgeting, savings and investment. They also supported by Chen and Volpe (2002) who measure financial literacy using specific knowledge about budgeting, savings, loans and investment. In addition, Lusardi and Mitchell (2007b) also used subtopics on health and retirement. And there are still many measurements of financial literacy using other specific knowledge.

Meanwhile, Allgood and Walstad (2016) explained that financial knowledge can be measured using two perspectives, namely perceived and actual financial literacy. They stated that financial literacy is associated with financial behaviour that covers five topics, namely: credit cards, investments, loans, insurance, and financial advice.

In another study, Henager and Cude explored financial literacy that uses objective knowledge about finance, subjective knowledge about finance, and subjective abilities in managing finances. Based on a study conducted by Lusardi and Mitchell (2007a), to determine the level of knowledge objectively used instruments that consist of five statements of true or false about compound interest, inflation, mutual fund vs stock diversification, mortgages, and bond pricing. Whereas subjective knowledge reflects the level of confidence in the financial understanding felt by respondents, this also shows the level of optimism (or pessimism) and several other factors including satisfaction. While Sivaramakrishnan et al. (2017) measured financial literacy using subjective financial literacy and objective financial literacy. Based on previous research, the measurement of financial literacy using a questionnaire was carried out depending on the objectives of each study.

Considering that the financial literacy variable examined in this study is Islamic Financial Literacy, thus, the construct of Islamic financial literacy developed in this study refers to the definition, dimensions, and indicators of financial literacy as well as referring to journals about Islamic financial literacy. Based on the definitions from PACFL and referring to indicators developed by Hidajat and Hamdani (2017) and Antara, Musa, and Hassan (2016), then the construct of Islamic financial literacy in this study is the ability of individuals to understand knowledge about the principles and contracts in Islamic finance in making financial decisions to achieve one's financial well-being.

## CONCLUSION

Based on the limited literature which explains the definition of Islamic Financial Literacy, so Islamic financial literacy in this study reflected the ability to understand knowledge using the dimension of Islamic principal and contracts. This study evolved the definition of Islamic financial literacy as the ability of individual to understand knowledge about the Islamic principles and Islamic contracts in financial decisions making to achieve one's financial well-being. Because the lack of study of Islamic financial literacy, this study suggests some further study which explore the measurement of Islamic financial literacy based on the definition in this study.

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