

**ROLES OF ISLAMIC BANKS IN IMPROVING
FINANCIAL INCLUSION OF SMES IN INDONESIA**

BY

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ABSTRACT

The notion of financial inclusion is currently perceived as a vital requirement for sustainable economic development. The concept was viewed initially as pro-poor growth and evolved later as a prerequisite to achieving economic stability and sustainability in the country. One of the critical pillars to promote financial inclusion is the Small and Medium Enterprises (SMEs) sector. In Indonesia particularly, SMEs are regarded as a critical engine for job creation and essential contributors to the country's Gross Domestic Product (GDP). Therefore, the inclusion of this potential sector into the Islamic financial services is exceptionally imperative to alleviate poverty, reduce unemployment, and minimise income disparity in the country. The primary objective of this study was to identify and explore the role of Indonesian Islamic banking institutions in realising financial inclusion by addressing the needs of Indonesian SMEs in the context of their services, analysing the issues and challenges that inhibit the institutions' ability to support the SMEs in gaining access to finance, and elucidate the endeavours of the Islamic banking institution to assist and reach over the SME segment through the regulatory, supply-side, demand-side and financial literacy determinants. This study incorporated the institutional theory as its theoretical premise and used qualitative methodology by adopting a multi-case study research strategy on the Indonesian Islamic banks (as the supply-side) in serving the needs of SMEs as well as the SME industry in its diverse sectors (as the demand-side). The research data were analysed by applying a content, narrative and discourse analysis to investigate the study's results and integrate the triangulation methods by comparing the three elements consisting of primary data, secondary data and theoretical proposition. The findings of this study implied that the Islamic banks present a substantial role in improving the financial inclusion of the SME segment through diverse strategies and approaches intended to facilitate its growth. Nevertheless, several issues and challenges still hamper the achievement of SME Islamic financial inclusion in Indonesia. Lack of incentives, Profit and Loss Sharing (PLS) implementation challenges, credit risk assessment gaps, high-price perception, issues of government programmes, and poor financial literacy of SMEs became the primary factors that negatively affect the achievement of Islamic financial inclusion for SMEs. Subsequently, the study also disclosed the SME entrepreneurs' expectations and perceptions towards the Islamic banks' products and services, denoting the opportunities that should be taken into consideration by the Indonesian Islamic banks. Additionally, the study is also expected to contribute to the empirical and theoretical analysis involving financial inclusion, Islamic banks, SMEs, and institutional theory aspects.

Keywords: Case Study, Financial Inclusion, Indonesia, Institutional Theory, Islamic Banks, SMEs

مُلخّص البحث

الشموليّة المالية مفهوم ضروري للتنمية الاقتصادية المستدامة، كانت بدايته للتنمية لدى الفقراء، ثم صار شرطاً رئيساً لتحقيق الاستقرار الاقتصادي في البلاد، وقطاع الشركات الصغيرة والمتوسطة من الركائز الأساس لتعزيز الشمولية المالية، وله في إندونيسيا فاعليته في إنشاء فرص العمل، وإسهامه في إجمالي الناتج المحلي للبلاد؛ لذا كان إدراجه في الخدمات المالية الإسلامية ضرورياً جداً للتخفيف من حدة الفقر، والحد من البطالة والتفاوت في الدخل، وعليه يهدف هذا البحث إلى استكشاف دور المؤسسات المصرفية الإسلامية الإندونيسية في تحقيق الشمولية المالية من خلال تلبية احتياجات الشركات الصغيرة والمتوسطة من حيث خدماتها، وتحليل الصعوبات التي تعوق قدرة تلك المؤسسات عن دعم هذه الشركات في الحصول على التمويل، وتوضيح مساعي المؤسسات لدعم الشركات من خلال المبادرات التنظيمية، وجانبي العرض والطلب، ومحددات التوعية المالية، فينبني البحث على "النظرية المؤسسية"، ويتوسّل المنهج النوعي بإستراتيجية بحثية متعددة الحالات في المؤسسات المصرفية الإسلامية الإندونيسية (بوصفها جانب العرض) في خدمة احتياجات الشركات الصغيرة والمتوسطة وصناعة مشاريعها (بوصفها جانب الطلب)، وكان تحليل البيانات من خلال تحليل المحتوى والسرد والخطاب للتحقق من نتائج البحث، والمقارنة بين البيانات الأولية والثانوية والاقتراحات النظرية، وأشارت النتائج إلى أن للمؤسسات المصرفية الإسلامية دوراً عظيماً في تحسين الشمولية المالية للشركات الصغيرة والمتوسطة من خلال تنفيذ إستراتيجيات متنوعة تهدف إلى تسهيل نموها، وعلى الرغم من ذلك؛ اتضحت معوقات كثيرة أمام تحقيق الشمولية المالية الإسلامية لتلك الشركات الإندونيسية، ثم إن ضعف الحوافز، والتحديات في تنفيذ مشاركة الأرباح والخسائر، والفجوات في تقييم مخاطر الائتمان، والتصوير بالسعر العالي، وقضايا البرامج الحكومية، وعجز التوعية المالية لدى الشركات؛ أصبحت كلها من العوامل الأساس التي تؤثر سلبياً في تحقيق الشمولية المالية الإسلامية لتلك الشركات، وكذا كشف البحث عن توقعات رجال الأعمال في قطاع الشركات الصغيرة والمتوسطة وتصوراتهم تجاه منتجات المؤسسات المصرفية الإسلامية الإندونيسية وخدماتها، مما يدل على الفرص التي يجب أن تأخذها هذه المؤسسات في الحسبان، ومن المتوقع أن يسهم هذا البحث في التحليل التجريبي والنظري من حيث الشمولية المالية، والمؤسسات المصرفية الإسلامية، والشركات الصغيرة والمتوسطة، والنظرية المؤسسية.

الكلمات المفتاحية: دراسة الحالة، الشمولية المالية، إندونيسيا، النظرية المؤسسية، المؤسسات المصرفية الإسلامية، الشركات الصغيرة والمتوسطة.

APPROVAL PAGE

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DECLARATION

I hereby declare that this thesis is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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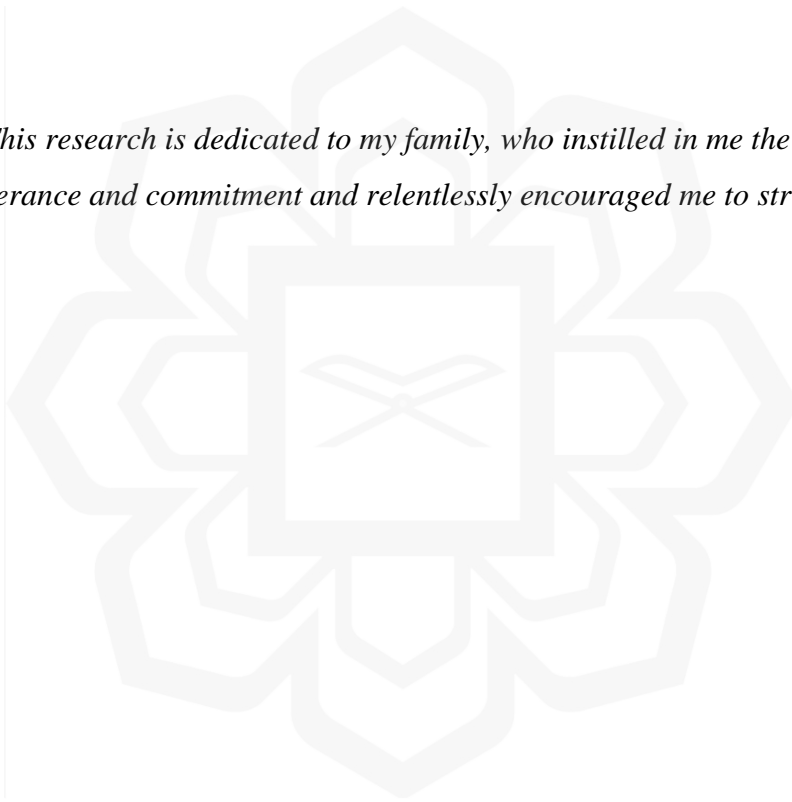
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This research is dedicated to my family, who instilled in me the virtues of perseverance and commitment and relentlessly encouraged me to strive for the best.



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LIST OF ABBREVIATIONS

| | |
|----------|---|
| 5C | Character, Capacity, Capital, Collateral and Condition |
| APEC | Asia-Pacific Economic Cooperation |
| APA | American Psychological Association |
| ATM | Anjungan Tunai Mandiri / Automated Teller Machine |
| Bappenas | Badan Perencanaan Pembangunan Nasional/ Ministry of National Development Planning |
| BCA | Bank Central Asia |
| BI | Bank Indonesia |
| BJB | Bank Jabar Banten |
| BKD | Badan Kredit Desa / Village Credit Bureau |
| BKK | Badan Kredit Kecamatan / Sub-District Credit Bureau |
| BKPD | Bank Karya Produksi Desa / Village Producers' Bank |
| BMT | Baitul Maal wa Tamwil / Islamic Zakat & Cooperatives Institution |
| BNI | Bank Negara Indonesia |
| BNM | Bank Negara Malaysia |
| BPD | Bank Pembangunan Daerah / Regional Government Bank |
| BPJPH | Badan Penyelenggara Jaminan Produk Halal / Halal Product Assurance Organising Body |
| BPJS | Badan Penyelenggara Jaminan Sosial Kesehatan / Social Security Administrator for Health |
| BPK RI | Badan Pemeriksa Keuangan Republik Indonesia / The Audit Board of the Republic of Indonesia |
| BPR | Bank Perkreditan Rakyat / Rural Bank |
| BPRS | Bank Pembiayaan Rakyat Syariah / Islamic Rural Bank |
| BPS | Badan Pusat Statistik / Statistic Center |
| BRI | Bank Rakyat Indonesia |
| BTM | Baitul Tamwil Muhammadiyah / Muhammadiyah Cooperatives |
| BTPN | Bank Tabungan Pensiunan Nasional / National Pension Fund Bank |
| BUKP | Badan Usaha Kredit Pedesaan / Rural Credit Enterprise |
| BUMN | Badan Usaha Milik Negara / State-owned Enterprise |
| BUS | Bank Umum Syariah / Islamic Commercial Bank |
| CAGR | Compound Annual Growth Rate |
| CIBAFI | General Council for Islamic Banks and Financial Institutions |
| CMEA | Coordinating Ministry for Economic Affairs |
| COVID-19 | Coronavirus Disease 2019 |
| CSR | Corporate Social Responsibility |
| DFI | Development Financial Institution |
| DFID | Department for International Development |
| Findex | Financial Index |
| Fintech | Financial Technology |
| FSP | Financial Service Provider |
| G20 | Group of Twenty (Is an international forum for the governments and central bank governors from 19 countries and the European Union) |
| GDP | Gross Domestic Product |
| GIEI | Global Islamic Economy Indicator |
| IDR | Indonesia Rupiah |

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|------------|---|
| IFC | International Finance Corporation |
| IFI | Islamic Financial Institution |
| IUM | International Islamic University Malaysia |
| ILO | International Labor Organisation |
| IMF | International Monetary Fund |
| IRTI | Islamic Research and Training Institute |
| IsDB | Islamic Development Bank |
| ISDP | Islamic Sociopreneur Development Programme |
| ISRA | International Shari'ah Research Academy |
| KNEKS | Komite Nasional Ekonomi dan Keuangan Syariah/ National Islamic Economy and Finance Committee |
| KNKS | Komite Nasional Keuangan Syariah / National Islamic Finance Committee |
| KPMI | Komunitas Pengusaha Muslim Indonesia / Indonesian Muslim Entrepreneur Community |
| KUR | Kredit Usaha Rakyat / People Business Credit |
| KURK | Kredit Usaha Rakyat Kecil / People's Small Enterprise Credit |
| LD-FEUI | Lembaga Demografi Fakultas Ekonomi dan Bisnis Universitas Indonesia/ Demographic Institute of Faculty of Economics, University of Indonesia |
| LDR | Loan to Deposit Ratio |
| LLP-KUMK | Lembaga Layanan Pemasaran Koperasi dan UKM / SMEs and Cooperatives Marketing Service Institution |
| LPDB-KUMKM | Lembaga Pengelola Dana Bergulir untuk Koperasi dan Usaha Mikro, Kecil dan Menengah / Institute for Managing Revolving Funds of Cooperatives and Micro, Small and Medium Enterprises |
| LPK | Lembaga Perkreditan Kecamatan / Sub-District Credit Institution |
| LPPI | Lembaga Pengembangan Perbankan Indonesia / Indonesian Banking Development Institute |
| MDG | Millennium Development Goal |
| MENA | Middle East North Africa |
| MFC | Multi Finance Company |
| MFI | Microfinance Institution |
| MIFC | Malaysia International Islamic Financial Centre |
| MoCSME | Ministry of Cooperatives and Small and Medium Sized-Enterprise |
| MSME | Micro, Small and Medium Sized-Enterprise |
| MUI | Majelis Ulama Indonesia/Indonesia Ulama Council |
| NFER | National Foundation for Educational Research |
| NPF | Non-Performing Financing |
| NPL | Non-Performing Loan |
| NPPKP | Nomor Pengukuhan Pengusaha Kena Pajak / Value Added Tax Collection Number |
| NPWP | Nomor Pokok Wajib Pajak / Taxpayer Registration Number |
| NTB | Nusa Tenggara Barat / West Nusa Tenggara |
| NTT | Nusa Tenggara Timur / East Nusa Tenggara |
| OCBC NISP | Oversea-Chinese Banking Corporation Nilai Inti Sari Penyimpan |
| OECD | Organisation for Economic Co-operation and Development |
| OJK | Otoritas Jasa Keuangan / Financial Service Authority |
| OLS | Ordinary Least Square |
| OSS | One-Stop-Shops |

| | |
|--------------|---|
| P2P | Peer to Peer |
| PBI | Peraturan Bank Indonesia / Bank Indonesia Regulation |
| PEFINDO | Pemeringkat Efek Indonesia/ Indonesia Credit Rating Agency |
| PEN | Pemulihan Ekonomi Nasional/ National Economic Resilience |
| Permenkumham | Peraturan Kementrian Hukum dan Hak Asasi Manusia / Ministry of Law and Human Rights Regulation |
| PKBL BUMN | Program Kemitraan Bina Lingkungan Badan Usaha Milik Negara/ Environmental Protection Partnership Programme of the State-Owned Enterprises |
| PLS | Profit and Loss Sharing |
| PLUT KUMKM | Pusat Layanan Usaha Terpadu Koperasi dan Usaha Mikro Kecil dan Menengah / Integrated Support Center for Cooperatives and Micro, Small and Medium Sized-Enterprise |
| PMK | Peraturan Menteri Keuangan/ Minister of Finance Regulation |
| POJK | Peraturan Otoritas Jasa Keuangan / Financial Service Authority Regulation |
| PRK | Pinjaman Rekening Koran / Overdraft Line Facility |
| PT | Perseroan Terbatas / Limited Company |
| QDA | Qualitative Data Analysis |
| RO | Research Objective |
| RQ | Research Question |
| SBI | Surat Bank Indonesia / Bank Indonesia's Bond |
| SDG | Sustainable Development Goal |
| SHGB | Sertifikat Hak Guna Bangunan/ Building Rights Title |
| SHGU | Sertifikat Hak Guna Usaha/ Cultivation Rights Title |
| SHM | Sertifikat Hak Milik / Freehold Title |
| SIUP | Surat Izin Usaha Perdagangan / Business Trading License |
| SKU | Surat Keterangan Usaha/Business Certificate |
| SLIK | Sistem Layanan Informasi Keuangan/ Financial Information Service System |
| SME | Small and Medium Sized-Enterprise |
| SMEDAN | Small and Medium Enterprise Development Agency of Nigeria |
| SMESCO | SMEs and Cooperatives |
| SNKI | Strategi Nasional Keuangan Inklusif/ National Strategy for Financial Inclusion |
| SOFIA | Survey on Financial Inclusion and Access |
| TDP | Tanda Daftar Perusahaan / Certificate of Company Registration |
| UKM | Usaha Kecil dan Menengah / Small and Medium Enterprise |
| UMKM | Usaha Mikro, Kecil dan Menengah / Micro, Small, and Medium Enterprise |
| UN | United Nations |
| USAID | United States Agency for International Development |
| UU | Undang-undang / Regulation |
| UUS | Unit Usaha Syariah / Islamic Business Units of Conventional Banks or Islamic Banking Window |

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

The concept of inclusive financing is dynamic and has evolved significantly since its inception. Once viewed as a means to alleviate poverty and reduce income disparity and inequality, in the current world, the concept has developed into an essential prerequisite for financial stability and economic development. Inclusive financial systems allow producers and households to smoothen their production and consumption of goods and services through which income is generated in an economy. Therefore, financial inclusion drives income generation by increasing productive capacity, especially among those without assets to start with and facilitates inclusive growth (World Bank, 2008; Sarma & Pais, 2011).

The success of the all-inclusive financial system can be achieved through the harmonisation and synchronisation of the core financial inclusion pillars that will be discussed in detail in the literature review. This pillar consists of public sectors, private sectors (like in the case of state-owned and private-owned Islamic banks), microfinance and SMEs, and financial literacy. These four key pillars are interrelated and need to interact seamlessly to realise successful financial inclusion, and this success will be translated later into sustainable economic development and accomplish Sustainable Development Goals (SDGs) (Chibba, 2009; Medici, 2016).

In this respect, the banking sector, as the core of the financial system, play a crucial role in realising the success of financial inclusion by giving the quality of financial product and services, providing easy access and procedures to the product and services, and ensuring the effective and efficient utilisation of these financial goods and services. In executing its role as the key driver of the all-inclusive financial system, the banking sector must be accompanied by supportive laws, regulations and legislation pertaining to access to financial goods and services. In this context, the banking industries serve as the fundamental pillar of financial inclusion that provides the means to achieve an all-inclusive financial system.

Small and Medium-sized Enterprises (SMEs), on the other hand, have a significant impact on the economic development of the country; the SMEs sector is frequently acknowledged by the government as a vital engine room for the creation of jobs and enhancement of economic growth. These sectors also contribute significantly to the Gross Domestic Product (GDP) growth around the world and also ensure that there is a proper flow of money across the economy. Due to the crucial role of SMEs in economic growth, the development of these sectors is deemed imperative to realise sustainable economic development since SMEs could potentially absorb a more exceptional workforce compared to larger enterprises (World Bank, n.d.; Nenova et al., 2009; Incubator, 2018). The main constraint faced by the SMEs sector to expand its business and continue its operation is often caused by financial constraints; therefore, a strong capital base is required by SMEs to ensure their continuity and sustainability (Beck, 2007; IFC, 2016; OECD, 2018; ILO, 2019).

The relationship between the banking sectors and SMEs sectors could potentially create a strong economic basis for development since the banking sectors provide a strong capital basis for the SMEs, while the SMEs provide wider and larger job provision to the economy; this mechanism will surely alleviate poverty, reduce unemployment, and lessen the gap of income disparity and inequality.

In the context of the Islamic financial system, financial inclusion is deemed crucial for the development of Islamic economics; hence, Shariah acknowledges the mechanism provided by the financial inclusion system for the better growth of the economy and the benefit of Muslim society. However, the achievement of financial inclusion in Islamic finance must abide carefully to the Sharia requirement of prohibiting *riba*, removing excessive uncertainty, preventing gambling and deceit transactions, and avoiding impermissible commodities and trade (Hassan, 2016). Furthermore, in treating the risk, the Islamic financial system is truly different compared to the conventional system; Islamic finance encourages the risk-sharing mechanism, whereas the conventional system prefers the risk-transfer mechanism. In this respect, the outcome of financial inclusion achievement is surely different compared to the conventional counterpart (Mirakhor & Iqbal, 2012).

Indonesia is one of the G20 countries and a member of the United Nations (UN) that promotes the realisation of financial inclusion to tackle the poverty and