Chapter 20

Issues and Challenges Facing Islamic Banks and MSME in Financial Inclusion in Indonesia

Adi Saifurrahman
Institute of Islamic Banking and Finance, International Islamic University Malaysia, Malaysia

Salina Kassim
Institute of Islamic Banking and Finance, International Islamic University Malaysia, Malaysia

ABSTRACT

Financial inclusion has become an important policy for many countries, including the developed and developing nations. Financial inclusion realisation is promoted by the easy and convenient access to financial services, quality of financial services, and efficient and effective utilisation by all segment of society, delivered with fairness and zero discrimination. The achievement of financial inclusion is supported by essential pillars that are interconnected with each other and form a composite economy ecosystem to ensure stability and sustainable development. One of these critical pillars is micro, small, and medium-sized enterprises (MSMEs); the development of MSMEs pillar is deemed crucial due to its capability in absorbing more considerable workforce compared to larger enterprises and contributes significantly to the gross domestic product (GDP). Therefore, the growth of MSMEs pillar will surely reduce poverty, lessen the unemployment, and lower the income disparity. In this respect, since Islamic banking represents the core of the Islamic financial system that encourages entrepreneurship, the institution is expected to take the lead in serving the needs of MSMEs sector and assisting them from all types of financial constraints. The primary objective of this chapter is to explore and investigate the critical issues and challenges of MSMEs financial inclusion achievement through the role of Islamic banking institutions, particularly in Indonesia. The chapter suggests several problems that hamper the role of the Indonesian Islamic banking institution in serving the needs of MSMEs and numerous issues and challenges in achieving MSMEs financial inclusion.

DOI: 10.4018/978-1-7998-6811-8.ch020
INTRODUCTION

The concept of the all-inclusive financial system is dynamic and has evolved remarkably since its initiation, the financial inclusion once perceived and recognised as a method to alleviate poverty and minimise income inequality and disparity. Currently, the concept has developed into a key prerequisite for financial stability and economic development since the all-inclusive financial system allows producers and consumers to smoothen their production and consumption of goods and services via which income is created in an economy. Hence, financial inclusion propels income generation by amplifying productive capacity, particularly among those with no asset to begin with and facilitates inclusive growth. The successful achievement of financial inclusion is realised through the harmonious connection among the financial inclusion pillars, which include the public sectors, private sectors, micro and small-medium enterprises, as well as financial literacy (Chibba, 2009). These pillars are interconnected with each other and require to interact seamlessly to form the successful economy ecosystem. The success of financial inclusion will inevitably accomplish sustainable economic development and achieve the Sustainable Development Goals (SDGs). In this regards, the banking sectors as the primary core of financial system play its vital function in achieving the success of all-inclusive financial system by providing quality financial services, giving convenient access and simple procedures to finance, and ensure the efficient and effective usage of financial products and services to the targeted clients.

Micro, Small, and Medium-sized Enterprises (MSMEs) sector on the other side, have a substantial impact on the economic growth of the country. The sector is perceived by the government as a crucial engine room for jobs creation and economic growth reinforcement. The sector also arguably contributes tremendously to the Gross Domestic Product (GDP) of many countries. With abovementioned fact, the growth of this sector is deemed critical to accomplish sustainable economic development, due to the fact that the MSMEs sector absorbs an exceptional workforce compared to the large company. It was featured in many studies that the primary constraint faced by the MSMEs sector to expand their business is access to finance. The sector needs a robust and reliable capital base to ensure its survivability in the market and sustainability in the economy.

The relationship between the banking sector and MSMEs sector could potentially generate a sturdy economic basis for development, since the Banking institution provide a strong capital basis for MSMEs, whereas the MSMEs sector generates greater job provision to the economy. This interconnected mechanism will inevitably assist in reducing poverty, minimising unemployment, and lowering the gap of income disparity among society.

In the perspective of the Islamic financial system, the accomplishment of an inclusive financial system is deemed vital for the growth of Islamic economy. Therefore, Shariah acknowledges the mechanism offered by financial inclusion system for the better development of the economy and welfare of the Muslim world. Nonetheless, the realisation of financial inclusion in Islamic finance should not neglect the Shariah ruling of prohibiting riba, excessive gharar, gambling, deceptive and unethical transaction, and avoiding impermissible trade and commodities. Moreover, in treating the risk, the Islamic financial system has different traits compared to the conventional systems. The former encourages the risk-sharing mechanism, whereas the latter prefers risk-transfer mechanism. In this regards, the result of financial inclusion accomplishment, according to the Islamic perspective, is genuinely different compared to the conventional counterpart.

In view of the above issues, the primary objective of this paper is to explore and identify the critical issues and challenges of MSMEs financial inclusion achievement through the role of Islamic banking
16 more pages are available in the full version of this document, which may be purchased using the "Add to Cart" button on the publisher's webpage: [www.igi-global.com/chapter/issues-and-challenges-facing-islamic-banks-and-msme-in-financial-inclusion-in-indonesia/274465](http://www.igi-global.com/chapter/issues-and-challenges-facing-islamic-banks-and-msme-in-financial-inclusion-in-indonesia/274465)

**Related Content**

**Determinants of IFRS Compliance by Canadian Companies**
[www.irma-international.org/article/determinants-of-ifrs-compliance-by-canadian-companies/174420](http://www.irma-international.org/article/determinants-of-ifrs-compliance-by-canadian-companies/174420)

**The Problems of Stage Acquisition Under the New Consolidation Accounting Standards**

**The Effect of International Financial Reporting Standards Adoption on Foreign Direct Investment and the Economy**
[www.irma-international.org/chapter/the-effect-of-international-financial-reporting-standards-adoptio](http://www.irma-international.org/chapter/the-effect-of-international-financial-reporting-standards-adoption-on-foreign-direct-investment-and-the-economy/248798)

**Innovative Revenue Collection Practices in South European Countries and the Case of Hellenic Independent Authority for Public Revenue**

**The Effect of Leverage on Investment, Dividends, and Company Value on the Real Estate Industry in Indonesia**
Dwi Atmanto (2020). *International Journal of Corporate Finance and Accounting* (pp. 54-70).
[www.irma-international.org/article/the-effect-of-leverage-on-investment-dividends-and-company-value-on-the-real-estate-industry-in-indonesia/261859](http://www.irma-international.org/article/the-effect-of-leverage-on-investment-dividends-and-company-value-on-the-real-estate-industry-in-indonesia/261859)