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Exploring the advantages and challenges of islamic banking and finance

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Abstract

This paper explores the advantages and challenges of Islamic banking and finance. Islamic finance is a growing sector in the global financial industry, with its unique features and principles that differentiate it from conventional finance. The paper delves into the advantages of Islamic finance, such as its ethical and socially responsible nature, and its potential for financial stability. On the other hand, the challenges of Islamic finance are also discussed, including the lack of standardization and harmonization among Islamic financial institutions, the complexity of Islamic financial products, and the shortage of skilled professionals in the field. Overall, the paper aims to provide a comprehensive overview of the advantages and challenges of Islamic banking and finance.

This study also compares Islamic Banks with Social Banks in GABV, which are two types of ethical financial institutions, which have successfully escaped the financial crisis, compared to conventional banking which is only profit-oriented, namely banks that must be liquidated or receive bailout funds when the global crisis occurs.

Keywords: Islamic Banking, Advantages, Challenges

Introduction

Islamic banking and finance have gained significant attention in recent years as an alternative to conventional banking systems. Islamic banking and finance are based on the principles of Shariah law, which prohibits interest (known as riba) and promotes risk-sharing, ethical investments, and social responsibility. In this article, we will explore the advantages and challenges of Islamic banking and finance.

Advantages of Islamic Banking and Finance

1. Ethical Investments: Islamic banking and finance focus on ethical investments that are socially responsible, environmentally sustainable, and support the well-being of communities. This approach aligns with the values of many customers who want their investments to make a positive impact on society.
2. Risk-Sharing: Unlike conventional banking, where the lender bears all the risks, Islamic banking and finance promote risk-sharing between the lender and the borrower. This approach reduces the likelihood of default and promotes a more equitable distribution of risk.
3. Stable Financing: Islamic banking and finance offer more stable financing options compared to conventional banking. This stability is due to the fact that Islamic finance is asset-based, meaning that financing is tied to tangible assets such as property or commodities, rather than speculative investments.
4. Financial Inclusion: Islamic banking and finance promote financial inclusion by providing services to individuals and businesses that may not have access to traditional banking services. This approach helps to reduce poverty and inequality by providing access to credit and financial services to underprivileged communities.

Challenges of Islamic Banking and Finance

1. **Limited Product Offerings:** Islamic banking and finance have a limited range of products compared to conventional banking. This limitation can make it difficult for customers to find products that meet their specific needs.
2. **Complex Contracts:** Islamic banking and finance contracts can be complex, requiring specialized knowledge and expertise. This complexity can make it difficult for customers to understand the terms and conditions of the contract.
3. **Lack of Standardization:** There is a lack of standardization in Islamic banking and finance, which can make it difficult for customers to compare products and services across different providers.
4. **Regulatory Challenges:** Islamic banking and finance face regulatory challenges in many countries due to the lack of clear legal frameworks and regulations. This situation can make it difficult for Islamic banks to operate in certain jurisdictions.

History The financial crisis in 1997-1998, the credit segment that was hardest hit was corporate credit, which had a large scale and risk. Micro and small loans are relatively safe because the risks are small, so there is an awareness that the bank's business is run by spreading the risk that initially focused on the corporation, then into the micro business. With the argument that if something happens to corporate credit, it can be compensated with other segments with better performance. This is the substance of the universal banking flow.

Although the involvement of banks in micro-scale businesses is growing rapidly, the degree of financial inclusion in Indonesia remains low. As an illustration, according to a World Bank survey, less than 50% of Indonesian families have bank accounts, and only 19% of Indonesians have savings in banks.

This data contrasts with the development of the telecommunications industry. Currently, almost all residents already have a cell phone. The penetration rate, namely the ratio of the number of telephones to the total population of 125%. This means that far more people have cellular phones than those with bank accounts or automated teller machines (ATM).

The population's still low access to banking services is an important reason for the high interest rates in banking, especially for micro loans. The inability of the poor to access formal banking causes them to fall into the valley of loan shark services (informal credit sector) whose interest rates are very high.

In this context the authors focus on Islamic banking in Indonesia, which is experiencing rapid growth and Social Banks as a comparison in financial inclusion, social mission and risk. Because of the uniqueness of Islamic banks and social banks that are members of the GABV [1], they are the two institutions that managed to escape the world crisis in 2007-2010, even social banks in Europe can come out as winners compared to conventional banks.

Methodology

In this paper, the research is focused on a comparative analysis of the performance of two types of banking and the measurement of bank soundness. The approach used is as follows

1. Comparative Analysis of the Performance of Two Types of Banking

The basic financial standards-CAR, ROA, ROE, and NPF-are used as benchmarks in the statistical analysis part to assess the socially responsible investment (SRI) performance of social banks and Islamic funds, or Sharia funds.

In order to limit their investments, social and sharia-based bank funds apply similar constraints (or filters), and both will therefore optimize their investments using unconventional investment analysis criteria.

The main financial literature states that both types of banking sectors in asset management should perform well over the long term, with lower returns at the same level of risk or better returns at the same level of risk. A relatively large database of results of Social and Islamic funds will be compared empirically with the help of statistical methods with each other.

Financial performance is a financial picture of every economic result achieved by banks in a certain period through their activities to generate profits efficiently and effectively, whose growth can be measured by analyzing financial data reflected in financial statements. For this reason, financial ratios are tools used to analyze the financial condition and performance of banks. This study measures various ratios, because in this way a useful comparison can be obtained rather than the raw numbers themselves, some of the financial ratios used are capital ratios (Solvency).

Then the ratio of NPL (Non-performing Loan) or in Islamic banks is referred to as NPF (Non-Performing Financing) to measure the ability of bank management in managing non-performing loans provided by banks. Credit risk accepted by the bank is one of the bank's efforts, resulting from uncertainty in loan repayment or resulting from non-payment of credit provided by the bank to the debtor.

Furthermore, there is a profitability ratio (Earning) which is used to analyze or measure the level of business efficiency and profitability achieved by the bank, the ratios used in this study are *Return on Equity and Return On Assets*.

Another way to find out if a bank is liquid is that the bank can fulfill its debt obligations, can repay its deposits, and can fulfill credit or loan requests without any suspension. This liquidity ratio is conducted to analyze the bank's ability to fulfill its obligations. In this study, the liquidity ratio used is Loan to Deposit Ratio (LDR) or in Islamic banks it is called FDR (Financing Deposit Ratio).

The recent financial crisis has revealed the flaws in mainstream conventional banking. Alternative banking methods are now in the spotlight as a result. However, there is significant geographic variety within the global social banking business. The authors concentrate on European social banks, a strong region in terms of social banking, to give a realistic comparison between social banks and Islamic

[1] GABV- Global Alliance for Banking on Value (2012), Full Report,http://www.gabv.org/wp-content/uploads/Full-Report-GABV-v9d.pdf. (accessedJanuary 2023).

commercial banks. The total assets in Europe are currently close to $14 billion. Over the past three years, they have doubled and continue to rise. Before the recent crisis, European social banks had seen significant expansion. Since then, their actions have advanced quickly. During the years 2007 through 2010, their assets grew on average every year at a rate greater than 20%.

European social banks are characterized by a dual purpose - social and financial, although they usually focus on social achievement as their main goal. In this context, financial concerns are justified by the need for economic sustainability rather than profit maximization. In addition, social banks are governed by key governance principles, such as transparency and responsibility. As for Islamic commercial banks, in this study selected Islamic commercial banks that were established before 2007-2010, a time when the global financial crisis occurred, which is the main topic of this research.

Table 1 Social Banks in GABV vs Islamic banks vs Commercial Banks

Descriptive Statistics (in %) data processed from Euro

Table 1: GABV (Global Alliance for Banking on Values)

Bank	Loan /asset	Deposit /asset	Capital /asset	ROA	ROE	Asset Growh (2007-2010)
GLS Bank (Germany)	76.28	85.91	9.25	0.4	8.32	111
Triodos (Holland)	60.88	86.95	14.96	0.36	3.4	54.87
Crédit Coop (France)	81.11	52.12	11.56	0.34	3.28	-1.75
Merkur Bank	64.14	81.48	13.37	0.04	0.33	54.87
Alternative Bank	74.7	92.78	11.90	0.04	0.7	60.32
Average	71.4	79.8	12.2	0.236	3.21	55.9
Stdv	(8,55)	(16)	(2.1)	(0.18)	(3.19)	(39.9)

Table 2: Commercial Banks in Europe

Deutsche Bank (Germany)	**21.4**	**28.02**	**7.83**	**0.14**	**5.5**	**-10.87**
Credit Suise (Swis)	21.21	27.86	14.48	0.49	14.4	-9.18
BNP (Perancis)	34.27	29.07	9.13	0.39	12.3	6.17
Barclays Bank (Inggris)	28.73	23.21	7.78	0.2	7.2	-5.96
ING (Belanda)	49.17	41	9.80	0.28	9.7	-14.45
Average	30.95	29.83	9.8	0.3	10.5	-6.86
Stdv	(11.55)	(6.64)	(2.75)	(0.14)	(3.8)	(7.9)

Source: Data processed from GABV and Commercial Banks in Europe

Table 3: Bank Syariah in Indonesia

Bank	Loan /asset	Deposit /asset	Capital /asset	ROA	ROE	Asset Growh (2007-2010)
Bank Syariah Mandiri	95.97	87.65	10.60	1.95	46.5	60
Bank Muamalat Indonesia	79.7	81	13.26	9.36	17.27	50.6
Bank Syariah Mega Indonesia	68	87	13.14	1.9	26.81	49.5
Average	73.85	85.2	12.3	4.4	30.2	53.4
Stdv	(8.2)	(3.67)	(1.5)	(4.3)	(14.9)	(5.8)

Table 5: Commercial Banks in Indonesia

Bank Mandiri	**54**	**80**	**13.4**	**3.5**	**33**	**22**
Bank BNI	54.8	78	18.6	2.5	24.7	26
Bank BCA	47.4	85.5	13.5	3.5	33.3	32.8
Bank Permata	69	80	14.1	1.9	21.5	46,7
Average	56.3 *(9.1)*	80.9	14.9	2.85	28	31.8
Stdv		*(3.22)*	*(2.5)*	*(0.79)*	*(5.9)*	*(10.8)*

Source: data processed from Bank Umum Syariah and Commercial Bank in Indonesia

From the presentation of table 1 shows social banks that are members of GABV versus conventional banks in Europe and Islamic banks versus conventional banks in Indonesia. The data is processed from the annual report of the Global Alliance for Banking on Values (GABV) and the annual report of Islamic Commercial Banks in Indonesia. All of them recorded assets above 10 trillion. The performance in table 1 shows that social banks are significantly larger for deposits / assets (3rd party funds compared to assets) than commercial banks in Europe, namely 79.8 compared to 29.8 as well as Islamic commercial banks are larger than commercial banks in Indonesia. , which is 85.2 compared to 80.9.

While Loans / assets (loans compared to assets), Social Banks and Islamic Commercial Banks are larger than commercial banks (71.4 vs 30.9 and 73.8 vs 56.3). Then the Return on Assets (ROA) is not significantly different between social banks and commercial banks, but there is a difference between Islamic commercial banks and commercial banks (4.4 vs 2.85).

Next, the Return on Equity (ROE) of social banks is lower than commercial banks, even lower than the ROE of Islamic banks. The ROE comparison of commercial banks in Indonesia is also lower than Islamic banks. A lower ROE indicates a social mission over a profit maximization mission.

In the data above for the level of capitalization, the difference in the ratio of capital to assets (capital over assets ratio), the table shows that social banks are larger than commercial banks, this shows that both social banks have significantly more capitalization than commercial banks. In Table 1, the asset growth of Islamic commercial banks is significantly no different from that of social banks around 53-55%.

The explanation of the facts above shows that both ethical financial institutions are stronger than commercial banks, this can be seen from Solvency (capitalization), liquidity and asset growth, even commercial bank assets for the period 2007-2110 growth were negative, The above reality shows that the social mission of Islamic banks in Indonesia has proven to be not optimal, the social mission is not yet visible (there is still profit maximization), this still leaves a few questions, which will be tested in measuring bank health.

The methodology used in this article is also a literature review. The literature review was conducted by searching for relevant articles, books, and reports related to Islamic banking and finance, its principles, practices, advantages, and challenges. The search was conducted using various databases, including Google Scholar, JSTOR, and EBSCOhost. The articles and reports were then analyzed and synthesized to provide an overview of the topic.

Islamic banking and finance have gained increasing attention in recent years as an alternative to conventional banking systems. The principles and practices of Islamic banking and finance are based on the principles of Shariah law, which promotes ethical investments, risk-sharing, and social responsibility. Islamic banking and finance offer many advantages, including financial inclusion, stable financing, and ethical investments. However, there are also challenges, including limited product offerings, complex contracts, lack of standardization, and regulatory challenges.

Other studies have examined the challenges faced by Islamic banking and finance, including the lack of standardization and regulatory challenges. For example, a report by the International Monetary Fund (IMF) (2015) highlighted the need for a regulatory framework that would promote the growth of Islamic finance while addressing the risks associated with this system. Another study by Kettell (2011) examined the complexity of Islamic finance contracts and the need for greater transparency and standardization in this area. the literature on Islamic banking and finance provides valuable insights into the principles, practices, advantages, and challenges of this system. Despite the challenges, Islamic banking and finance offer many advantages, including ethical investments, financial inclusion, and stable financing. To address the challenges, there is a need for greater standardization, transparency, and regulatory frameworks that would promote the growth of Islamic finance while addressing the risks associated with this system.

Results & Discussion

From the results of Regression presenting and analyzing descriptive statistics, the independent variables of Islamic banking, social banks and conventional banks with EVIEWS 8 software, show that the credit risk of Ethical banks (Islamic banks and social banks), with the hypothesis H_0: residual distribution has been distributed normally and through probability Jarcue-Bera and 95% significance level (α =5%)

Regression results, factors that influence credit risk ethical banking (represented by Islamic banks and social banks) For Ethical banking, the variables ROA, CAR, ASSET, LDR EQTA, are significantly related to credit risk, while the r square which is 60.2 5 in ethical banking shows that These variables collectively have a strong influence of 60.2 5 on credit risk, the remaining 39.85 are influenced by other factors. While the asset coefficient is statistically significant at a significance level of 90% (α= 10%) related to credit risk in ethical banks.

Islamic banking and finance have gained increasing attention in recent years due to their unique characteristics and principles that differ from conventional banking and finance. The advantages and challenges of Islamic banking and finance have been the subject of much debate and research. In this study, we explored the advantages and challenges of Islamic banking and finance to provide a comprehensive understanding of this emerging sector.

Islamic banking and finance have several advantages over conventional banking and finance. One of the most significant advantages is that Islamic finance is based on ethical and moral principles, which promotes social justice and fairness. Islamic finance emphasizes risk-sharing, which means that both parties involved in a transaction share the risks and benefits. This approach promotes financial stability and mitigates the risk of financial crises.

Another advantage of Islamic banking and finance is that it offers a wide range of financial products and services that cater to the needs of Muslim customers. For instance, Islamic finance provides alternative financing options for individuals and businesses that are not available in conventional banking. Islamic finance also prohibits the charging of interest, which is seen as exploitative and unfair.

However, Islamic banking and finance also face several challenges. One of the main challenges is the lack of standardization and harmonization of Islamic financial practices and regulations. This can lead to confusion and inconsistency in the application of Islamic financial principles, which can undermine the credibility and trust of Islamic finance.

Another challenge is the limited availability of skilled human resources and expertise in Islamic finance. The shortage of qualified professionals in Islamic finance can limit the growth and development of the industry, and may also hinder the implementation of effective risk management practices.

Conclusion

By comparing two types of banks, namely Social Banks and Islamic Banks and measuring banking health, there are several things that can be concluded and are related to the initial hypothesis.

The results of the study show that the two ethical financial institutions are stronger than conventional banks, this can be seen from the solvency (capital), liquidity and asset growth, even when the assets of conventional banks for the period 2007-2110 grew negative.

In conclusion, Islamic banking and finance have both advantages and challenges. While Islamic finance offers a unique and ethical approach to financial intermediation, it also faces several challenges that need to be addressed to ensure its continued growth and development. This study highlights the need for further research and collaboration among Islamic financial institutions, regulators, and scholars to overcome these challenges and promote the growth and development of Islamic banking and finance.

Islamic banking and finance offer many advantages, including ethical investments, risk-sharing, stable financing, and financial inclusion. However, there are also challenges, including limited product offerings, complex contracts, lack of standardization, and regulatory challenges.

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