

THE EVOLUTION OF ISLAMIC BANKING IN INDONESIA: CHALLENGES, OPPORTUNITIES, AND FUTURE PROSPECTS

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ABSTRACT

This study aims to analyse the development of Islamic banking in Indonesia through a literature review approach. The study was conducted by examining scientific journals, books, official regulations, and reports from relevant authorities, which were then categorised thematically to provide a comprehensive overview. The results of the study show that Islamic banking has made significant progress since the establishment of Bank Muamalat Indonesia in 1992 to the formation of Bank Syariah Indonesia in 2021. This development is supported by regulations, including Law Number 21 of 2008, as well as authority policies that strengthen institutional structures. However, the market share of Islamic banking is still limited, public literacy is low, and the availability of competent human resources is inadequate. Nevertheless, growth opportunities exist through government support, digital transformation, and sustainable finance trends aligned with Islamic principles. This study has limitations because it relies solely on a literature review, so the findings are conceptual. Therefore, further studies are recommended to use empirical methods to assess the effectiveness of policies and digitalisation strategies, and to compare the performance of Islamic banking with that of conventional banking.

Keywords: Islamic Banking, Challenges, Opportunities, Islamic Finance, Innovation

ABSTRAK

Penelitian ini bertujuan menganalisis perkembangan perbankan syariah di Indonesia melalui pendekatan kajian pustaka. Kajian dilakukan dengan menelaah jurnal ilmiah,

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buku, regulasi resmi, serta laporan dari otoritas terkait, yang kemudian dikategorikan secara tematik untuk memberikan gambaran menyeluruh. Hasil penelitian menunjukkan bahwa perbankan syariah telah mengalami kemajuan signifikan sejak berdirinya Bank Muamalat Indonesia pada tahun 1992 hingga terbentuknya Bank Syariah Indonesia pada tahun 2021. Perkembangan ini didukung oleh regulasi, termasuk Undang-Undang Nomor 21 Tahun 2008, serta kebijakan otoritas yang memperkuat struktur kelembagaan. Meskipun demikian, pangsa pasar perbankan syariah masih terbatas, literasi masyarakat rendah, dan ketersediaan sumber daya manusia kompeten belum memadai. Namun, peluang pertumbuhan terbuka melalui dukungan pemerintah, transformasi digital, serta tren keuangan berkelanjutan yang sejalan dengan prinsip syariah.

Kata kunci: Perbankan Syariah, Tantangan, Peluang, Keuangan Syariah, Inovasi

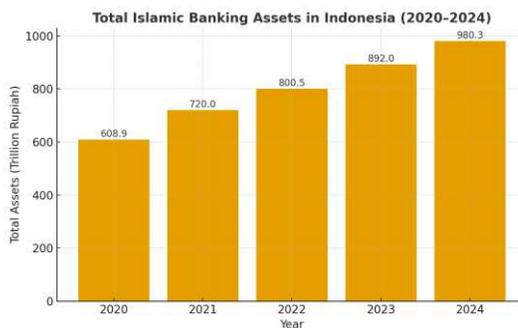
1. INTRODUCTION

Islamic banking is one of the fastest-growing sectors of the Indonesian financial system. As a country with a majority Muslim population, Indonesia has great potential in developing a sharia-based economic system (Hasan, 2019). Islamic banking not only offers an alternative for people who want to transact in accordance with Islamic principles but also becomes part of the national financial system, contributing to economic growth (Abasimel, 2023).

In recent years, the Islamic banking industry has experienced significant growth. Data as of June 2023 showed that total Islamic banking assets reached Rp 2,450.55 trillion, accounting for 10.94% of the national financial industry's total assets (Anwar et al., 2020). This growth is supported by government policies, such as Law No. 21/2008 on Islamic Banking, which provides a stronger legal foundation for the industry (Rizwanti, 2023). In addition, increased public awareness of sharia-based financial systems has further strengthened Indonesia's Islamic banking ecosystem (Mohammed & Muhammed, 2017).

The following table shows total Islamic banking assets in Indonesia from 2020 to 2024.

Figure 1. Total Islamic Banking Assets in Indonesia from 2020 to 2024



Source: OJK, 2025

By the end of 2024, Islamic banking assets reached IDR 980.30 trillion, up 9.88% from the previous year, with market share rising to 7.72%. However, despite the positive growth, the Islamic banking industry still faces various challenges (Bilan et al., 2019). One of the main obstacles is the low level of Islamic financial literacy, which results in a lower penetration rate of Islamic banking than conventional banks (Rizvi et al., 2020). In addition, competition with conventional banks, limited product innovation, and a shortage of competent human resources (HR) in Islamic finance are challenges that must be overcome (Salman et al., 2024).

On the other hand, the opportunities for developing Islamic banking in Indonesia remain substantial. Regulatory support from the government, such as Law No. 10 of 1998 and Law No. 21 of 2008, continues to stimulate this industry (Sari & Mugiayati, 2024). In addition, the development of Islamic fintech, the increasing need for financing for Micro, Small, and Medium Enterprises (MSMEs), and the adoption of digital technology further strengthen the growth potential of Islamic banking (Santika et al., 2024).

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2. LITERATURE REVIEW

2.1 THE CONCEPT OF ISLAMIC BANKING

Islamic banking is a financial institution that conducts business activities in accordance with Islamic principles, particularly the prohibitions on *riba*, *gharar*, and *maisir*. In practice, Islamic banks develop products and services using contracts such as *mudharabah*, *musyarakah*, *murabahah*, *ijarah*, and *wakalah*. The main principles applied are fairness, transparency, and risk-sharing between the bank and its customers. The fundamental difference with conventional banking lies in how profit and risk are managed. While conventional banks rely on interest, Islamic banks use a profit-and-loss sharing system. This concept means that Islamic banking is not only oriented towards financial profit, but also emphasises ethical, social, and sustainability values (Antonio, 2001).

Islamic banking in Indonesia has experienced rapid development in recent decades. Regulatory support, such as Law No. 21 of 2008 on Islamic Banking, has provided a stronger legal foundation, enabling Islamic banks to compete more effectively in the national financial industry (Santika et al., 2024). As of June 2023, total Islamic banking assets reached IDR 2,450.55 trillion, accounting for 10.94% of the national financial industry's total assets. This growth is also supported by the increasing number of Third Party Funds (DPK) and financing disbursed (PYD), which indicate growing public confidence in the sharia-based financial system (Rahmayati, 2021).

In addition to regulatory factors, increasing public awareness of the importance of sharia-based financial systems is also a supporting factor for the growth of this industry. Islamic banks in Indonesia have adopted various sharia-based business models, such as *mudharabah*, *musyarakah*, *ijarah*, and

murabahah, which offer a more ethical and transparent financial alternative for the community (Abasimel, 2023).

2.2 HISTORY OF ISLAMIC BANKING IN INDONESIA

The history of Islamic banking in Indonesia began in 1992 with the establishment of Bank Muamalat Indonesia (BMI), the country's first Islamic bank. This initiative arose from the Muslim community's awareness of the need for a Sharia-compliant financial system. Furthermore, the 1997–1998 economic crisis created opportunities for the development of Islamic banks, as they were more stable than conventional banks at the time (Said, 2012).

A significant milestone in this development was the enactment of Law No. 21 of 2008 on Islamic banking. This law provides a strong legal basis for the operation of Islamic banks, including the regulation of products, institutions, and supervision. Since then, Islamic banks have grown more rapidly, supported by regulations and increased public literacy (Albaity & Rahman, 2019).

The latest development is the merger of three state-owned Islamic banks, BRI Syariah, Bank Syariah Mandiri, and BNI Syariah into Bank Syariah Indonesia (BSI), which took place on 1 February 2021. This merger aims to strengthen the capital structure, expand the network, and enhance the competitiveness of Indonesian Islamic banks globally (Rizwanti, 2023).

2.3 ROLE OF AUTHORITIES AND REGULATIONS

Bank Indonesia (BI) and the Financial Services Authority (OJK) play a central role in regulating and supervising Islamic banking. Prior to the establishment of the OJK, BI was responsible for formulating monetary policy and supervising Islamic banks. However, since 2011, this function has been transferred to the OJK, enabling BI to focus more on monetary policy and payment systems (Paulus, n.d.).

Additionally, the National Sharia Council–Indonesian Ulema Council (DSN-MUI) issues fatwas that serve as the legal basis for Islamic banking products and services. DSN-MUI fatwas serve as a reference for the OJK and BI when drafting technical regulations (Andriansyah, 2023).

Through the National Committee for Islamic Economics and Finance (KNEKS), the Indonesian government has also developed a roadmap for developing the national Islamic economy and finance. This policy emphasises the integration of Islamic banking with the real economy, the digitalisation of services, and the improvement of public financial literacy (Saputra & Sugiarti, 2024).

3. RESEARCH METHODS

This study uses a literature review method to trace, identify, and synthesise the development of Islamic banking in Indonesia, drawing on various existing

sources (Aris et al., 2024). The literature used includes scientific articles from national and international journals that are relevant to Islamic banking; books and academic works that discuss the basic concepts and history of Islamic banking; and official regulatory documents, such as Law No. 21 of 2008; Financial Services Authority (OJK) regulations; and Bank Indonesia (BI) regulations. It also includes annual reports and industry statistics from relevant institutions, such as BI, OJK, and KNEKS.

Literature was selected based on relevance to the research topic, credibility of the source, and recency. Literature from the last ten years was prioritised to provide an up-to-date overview, although classical literature was also used to provide historical context (Mambodallu, 2018).

The analysis process was carried out in three stages. First, relevant documents were collected by searching academic databases and official government sources. Secondly, the literature was categorised into the following main themes: the concept of Islamic banking; its historical development; regulations and the role of authorities; and challenges and opportunities. Thirdly, the study's results were synthesised by compiling them into a narrative, comparing various findings, and highlighting important issues arising in the development of Islamic banking in Indonesia (Kammer et al., 2015).

4. RESULTS AND DISCUSSION

4.1 DYNAMICS OF ISLAMIC BANKING DEVELOPMENT IN INDONESIA

Islamic banking in Indonesia has experienced significant growth in recent years. As of June 2023, total Islamic banking assets reached Rp 2,450.55 trillion, accounting for 10.94% of the national financial industry's total assets. This increase shows that people increasingly believe in the sharia-based financial system (Saba et al., 2019). This growth is also supported by various government policies, such as Law No. 21 of 2008 on Islamic Banking, which provides a stronger legal foundation for the industry's development (Demirdögen, 2021).

Table 2. Development, Challenges, Opportunities, and Strategies of Islamic Banking in Indonesia

Aspect	Data/Information
Development	<ul style="list-style-type: none">- Islamic banking assets reached IDR 2,450.55 trillion as of June 2023.- The market share of Islamic banks reached 10.94% of the total national financial industry.- Increase in Third-Party Funds (DPK) and distributed financing (PYD).- Law No. 21 of 2008 strengthens the regulation of Islamic banking.

Aspect	Data/Information
Challenges	<ul style="list-style-type: none"> - Low Islamic financial literacy, leading to limited market penetration. - Competition with conventional banks, as the public is more familiar with the interest-based system. - Lack of product innovation, making it less flexible compared to conventional banks. - Limited capital and a shortage of skilled human resources in the Islamic finance industry.
Opportunities	<ul style="list-style-type: none"> - Government regulatory support, such as Law No. 10 of 1998 and Law No. 21 of 2008. - SMEs require access to more flexible and fair Islamic financing. - Rapid growth of Islamic fintech, enhancing access to digital-based Islamic banking services. - Increasing public awareness of Islamic economics as a fair and just system.
Strategies	<ul style="list-style-type: none"> - Product and service innovation, such as developing mudharabah and musyarakah contracts. - Digitalization of services, including Islamic mobile banking and e-wallets to improve efficiency. - Enhancing human resource competencies through training and Islamic finance certification. - Sharia-based risk management with a risk-sharing approach in line with Islamic principles. - Collaboration with Islamic fintech and zakat/waqf institutions to expand service coverage. - CSR and community empowerment programs to strengthen customer loyalty and trust.

Source: Research data analyzed

In addition, the development of digital technology has also contributed to improving Islamic banking services. Innovations such as sharia mobile banking, sharia-based e-wallets, and the digitization of financial services make it easier for people to access Islamic banking products (Todorof, 2018).

4.2 CHALLENGES IN THE DEVELOPMENT OF ISLAMIC BANKING

Despite positive growth, the Islamic banking industry still faces various challenges. One of the main obstacles is the low level of Islamic financial literacy, which has led to low market penetration and public preference for conventional banks. In addition, competition with conventional banks that

offer more flexible products is a challenge that Islamic banking must face (Kabir & Worthington, 2017).

Another challenge faced is the lack of innovation in Islamic financial products, which makes it difficult to compete with the flexibility of conventional bank services. In addition, limited capital and competent human resources (HR) in Islamic finance are significant obstacles to the industry's development (Kassim, 2016).

Despite its rapid growth, Islamic banking in Indonesia still faces various challenges that need to be addressed. The main challenges faced include (Ahmad et al., 2021):

1. Low Islamic Financial Literacy

There are still many people who do not understand the differences between Islamic and conventional banks, especially regarding the concepts of Islamic contracts such as *mudharabah*, *musyarakah*, and *ijarah*. This lack of education has led to a lower penetration of Islamic banking than conventional banks (Razak, 2018).

2. Competition with Conventional Banks

Conventional banks remain superior in terms of the flexibility of their financial products and services. Some customers remain hesitant to switch to Islamic banking because they view the system as more limited and less competitive (Hidayah, 2021).

3. Lack of Product Innovation

Islamic banking products are still not as varied as conventional banks. This prevents Islamic banking from attracting a broader customer segment (Mohamed, 2022).

4. Limited Capital and Competent Human Resources

The Islamic banking industry still faces limited capital for business expansion. In addition, the number of human resources (HR) with expertise in Islamic finance remains limited (Ayedh & Echchabi, 2015).

These challenges suggest that the development of Islamic banking requires not only regulatory support but also structural changes within the industry itself. Low financial literacy highlights the need for more intensive public education, while competition with conventional banks emphasises the importance of product diversification and service innovation. Similarly, the lack of capital and skilled personnel underscores the need for institutional strengthening for sustained growth. In short, the future of Islamic banking depends on its ability to improve human capital, expand financial literacy programmes, and innovate products that can compete with conventional alternatives.

4.3 OPPORTUNITIES IN THE DEVELOPMENT OF ISLAMIC BANKING

Amid various challenges, Islamic banking in Indonesia also offers significant opportunities for continued growth. Some of the factors that support this opportunity include (Ahmed & Legass, 2025):

1. Government Regulatory Support

The government continues to encourage the growth of Islamic banking through various policies, such as Law No. 10 of 1998 and Law No. 21 of 2008, which provide legal certainty for this industry (Santoso & Ahmad, 2016).

2. Growth of the MSME Sector

MSMEs need fairer, more affordable access to financing. Islamic banking has significant potential to provide financing through profit-sharing contracts that are more profitable for MSMEs than interest-bearing credit systems (Elasrag, 2016).

3. Sharia Digitalization and Fintech

The growing use of sharia-based financial technology (sharia fintech) creates opportunities for Islamic banks to reach more customers, especially the younger generation, who are more accustomed to digital services (Salyani & Sonko, 2022).

4. Increasing Public Awareness of Islamic Finance

Public awareness of the importance of a financial system based on sharia ethics and principles is increasing, potentially encouraging more people to switch to Islamic banking (Habib, 2018).

Despite facing various challenges, Islamic banking in Indonesia has great potential for continued growth. One of the strongest sources of support comes from the government through regulatory frameworks, such as Laws Nos. 10 of 1998 and 21 of 2008, which provide legal certainty for the existence and operation of Islamic financial institutions (Santoso & Ahmad, 2016). Consistent regulatory support not only legitimises the industry but also creates an environment conducive to further expansion (Ahmed & Legass, 2025).

Another important driver is the growth of micro, small, and medium-sized enterprises (MSMEs). As the backbone of the Indonesian economy, MSMEs require financing schemes that are fairer and more accessible. Islamic banking, with its profit-sharing contracts, offers a beneficial alternative to conventional credit systems based on interest (Elasrag, 2016). This creates a natural synergy between the mission of Islamic banks and the financing needs of MSMEs, which, if properly managed, could accelerate inclusive growth.

Digital transformation also brings new opportunities. The rise of Sharia-compliant financial technology (fintech) enables Islamic banks to access previously hard-to-reach segments of society, particularly the younger generation who are more familiar with digital services (Salyani & Sonko, 2022). This indicates that Islamic banks' competitiveness will increasingly depend on their ability to integrate with digital ecosystems.

Finally, growing public awareness of ethical and Sharia-based financial systems has the potential to shift consumer behaviour towards Islamic banking (Habib, 2018). Combined with supportive regulations, digital innovation, and the financing needs of MSMEs, this awareness strengthens the argument that Islamic banking in Indonesia is a strategic component of sustainable financial development and an alternative system.

4.4 ISLAMIC BANKING DEVELOPMENT STRATEGY

Despite the challenges, Islamic banking offers significant growth opportunities in Indonesia. Regulatory support from the government, such as Law No. 10 of 1998 and Law No. 21 of 2008, continues to drive the industry toward greater competitiveness. In addition, the increasing demand for Islamic financing from the MSME sector provides greater expansion opportunities for Islamic banks (Adekoya, 2022).

Technological advancements also create significant opportunities through the development of Sharia Fintech, which makes digital banking services more accessible to the public (Riza & Wijayanti, 2024). In addition, increasing public awareness of Islamic economics as a fairer, more equitable system strengthens Islamic banking's position in the national financial industry (Kusuma et al., 2024).

To overcome challenges and capitalize on opportunities, an effective development strategy is needed. Some strategies that can be implemented include (Lesmana et al., 2024):

1. Product and Service Innovation

Islamic banking needs to continue developing products based on *mudharabah* and *musyarakah* contracts to compete with conventional banks and meet market needs (Sokris et al., 2024).

2. Digitalization of Banking Services

Digital transformation is an important step in improving accessibility and efficiency of services, such as through Sharia mobile banking and Sharia e-wallets (Abdeldayem & Aldulaimi, 2023).

3. HR Competency Improvement

Training and certification for the workforce in the Islamic banking sector are needed to improve service quality and the competitiveness of this industry (Mbawuni & Nimako, 2018).

4. Sharia-based Risk Management

Implementing a risk-sharing approach in accordance with Sharia principles will increase transparency and customer confidence (Hassan et al., 2019).

5. Collaboration with Islamic Fintech and Zakat/Wakaf Institutions

Collaboration with other Islamic financial institutions can expand service coverage and enhance Islamic banking's competitiveness (Jouti, 2019).

6. CSR and Community Empowerment Programs

Islamic banking can increase public trust and loyalty through Corporate Social Responsibility (CSR) programs that empower people's economies (Mohamad et al., 2017).

These strategies demonstrate that the development of Islamic banking involves more than just expanding products or market share; it also involves strengthening institutional capacity and public trust. Product and service innovation ensures the industry remains relevant to market needs, and digitalisation makes it more accessible to younger, tech-savvy generations. Meanwhile, improving HR competencies and implementing Sharia-based risk management provides the foundation for sustainable growth. Collaborating

with fintech and zakat or waqf institutions reflects the integrative role of Islamic banking in the commercial and social spheres. Meanwhile, CSR initiatives reinforce Islamic finance's ethical and community-oriented image, distinguishing it from conventional banking.

Based on this literature review, although Islamic banking in Indonesia has experienced rapid development, various challenges remain to be overcome. However, with innovative strategies, strong regulatory support, and the utilization of digital technology, the Islamic banking industry can continue to grow and make a greater contribution to the national economy (Meisamy & Gholipour, 2020).

From this discussion, it is clear that Islamic banking in Indonesia is experiencing strong growth. Still, it faces several challenges, including low Islamic financial literacy, competition with conventional banks, and limited product innovation and capital. However, with regulatory support, the growth of the MSME sector, the digitization of services, and increasing public awareness of Islamic finance, the opportunity to continue to grow remains substantial. By implementing product innovation strategies, digital transformation, strengthening human resources, and collaboration with Islamic fintech, Islamic banking can become more competitive and contribute more to the national economy.

5. CONCLUSION

Based on the results of this study, it can be concluded that Islamic banking in Indonesia has experienced significant growth, marked by an increase in total assets to IDR 2,450.55 trillion as of June 2023, and a market share of 10.94% of the total national financial industry. Regulatory support, increased Islamic financial literacy, and the development of digital technology are the main drivers of this industry's growth. Despite positive developments, Islamic banking still faces several challenges. The main challenge is the low level of Islamic financial literacy, which results in lower market penetration than conventional banks. In addition, competition with conventional banks, limited product innovation, and limited capital and competent human resources are obstacles to the industry's growth. On the other hand, there are great opportunities for Islamic banking to continue to grow. Government regulatory support, such as Law No. 10 of 1998 and Law No. 21 of 2008, has provided legal certainty for this industry. In addition, the growth of the MSME sector, which requires access to sharia-based financing, and the digitalization of banking services through sharia fintech further open the door to wider expansion.

To overcome existing challenges and capitalize on available opportunities, Islamic banking must implement several strategies. These strategies include product and service innovation, digital transformation through mobile banking and sharia e-wallets, improving human resource competencies through training and certification in sharia finance, and

implementing sharia-based risk management. In addition, collaboration with Islamic fintech and zakat/wakaf institutions can be a strategic step in expanding service coverage and increasing competitiveness. By implementing the right strategies, Islamic banking in Indonesia has great potential to become a more competitive and inclusive financial sector. In addition to providing a more ethical and Sharia-compliant financial alternative, Islamic banking can also contribute more to driving national economic growth and improving people's welfare. However, Islamic banking's contribution to the total national banking industry remains limited, with a market share that does not yet reflect the enormous potential of Indonesia's Muslim population. The main challenges that need to be addressed are low Islamic financial literacy, a shortage of competent human resources, and uneven digitalisation readiness. Conversely, there are significant opportunities for development through government policy support, global trends in sustainable finance, and the potential utilisation of financial technology.

This study's limitations lie in its approach, which relies solely on a literature review, yielding conceptual findings unsupported by empirical field data. Therefore, further research using quantitative and qualitative methods, such as surveys, interviews, or analysis of Islamic banking financial data, is recommended to provide a more comprehensive picture. This study is therefore expected to provide policymakers, banking practitioners, and academics with a basis for understanding the dynamics of Islamic banking development in Indonesia, while also triggering further applicable, data-driven research.

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