

The Effect of Innovation to Increase Growth Islamic Banking: Comparison of Islamic Banking Growth in Indonesia and Pakistan

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Abstract— *This article aims to see and compare the development of Islamic banking in Pakistan and Indonesia, with innovation indicators as the primary comparative justification. This study uses quantitative justification on available secondary data related to the growth of Islamic banking and qualitative justification that compares the impact of innovation on the development of these banking. The essential findings are that Islamic banking in Indonesia has very rapid growth compared to Pakistan, which incidentally has operated Islamic banking for a longer time. There are several reasons for these findings, including the population and distribution of Indonesia's territory, which is much larger than Pakistan. However, today's banking challenges are more widely accepted by Indonesian Islamic banking, where technological factors heavily influence growth. Therefore, growth occurs by adapting innovations in banking organizations in Indonesia. Innovation is carried out by applying technology in banking business processes and strategic actions, such as the merger of Islamic banks to form the strength of Indonesia's most prominent Islamic bank.*

Keywords: Indonesian Islamic Banking, Innovation, Islamic Banking, Pakistan Islamic Banking.

1. INTRODUCTION

Islamic finance has become a global phenomenon marked by the increasing number of Islamic financial institutions and positively impacts development finance in a world that promotes universal moral values; justice, honesty, and ethics [1][17]. Various scientific studies have proven that Islamic finance is more resistant to financial crises, so financial implementation is not expected Islam will prosper pretty and equitably. The era of globalization and the phenomena of financial-economic development in the world has given many opportunities and challenges, especially in the development of Islamic finance. Therefore, for the development of the Islamic financial economy in the future, apart from learning from the successes and failures of the conventional financial economy with the various crises that occurred, it is also necessary to take advantage of new approaches that have been developed, creative and innovative [2][4].

The history of Islamic banking in Indonesia was first pioneered by Bank Muamalat Indonesia, established in 1991. This bank was initially initiated by the Indonesian Ulema Council (MUI) and the Government and received support from the Indonesian Muslim Intellectuals Association (ICMI). Law number 7 was issued by the Government in 1992, which concerns banking operations by a profit-sharing concept as a new banking system.

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Then in 1998, there was a change added concerning banking. This change further encouraged the bank to develop its operations as the existence of the Islamic banking system in Indonesia. Based on that developing law, Commercial Banks were allowed to develop their business activities according to Islamic principles by opening Islamic Business Units. Law No. 21 of 2008 regulates several new provisions in Islamic banking, including fatwa authority and Islamic banking committees, Islamic guidance and supervision, selection of Islamic supervisory boards, tax issues, banking dispute resolution, and conversion of Islamic business units into Islamic commercial banks. Until the End of 2020, Islamic banking will continue to show growth[3][5].

In today's modern era, many factors can drive the success of a business or company, including the Islamic banking business. Bank success can come from banking products that are useful and much needed by consumers to create services that are responsive to the community's needs[7]. One of the indications of an increase in the business is the organization's development, in this case, the growth of the business with the addition of new units/business branches. The more the number of branches that grows results in the more significant the bank's organization, which correlates with the better the possibility of sales to the bank.

One of the factors that can be a critical factor in the success of companies that lead the industry today. According to Northeastern.edu, innovation is a concept that focuses on the processes carried out by organizations in making new ideas for new products and services [8]. The form of innovation in the business climate is very varied and very much depends on the goals to be achieved by the company when facing these changes, for example, product and service innovation, internal systems, or work processes in the organization, to renewed business models. According to an explanation of the effect of innovation on the business development of Islamic banks, it is necessary to explain whether innovation is a factor influencing the growth of Islamic banking. Completion of the hypothesis by considering developments that occur and correlate with innovations carried out by banks in the industry.

2. THEORITICAL REVIEW

Northeastern.edu (2019) defines innovation as creating new things that produce renewable products and services. In a business context, innovation can run more simply by changing or modifying the current business model or by adapting to changes that occur in the market to produce products and services that are responsive to market demands. The primary purpose of this innovation is organizational development, to give new colors to new products and services.

Innovation at least plays an essential role in the following [9][11][12]:

Encouraging business growth, Companies can choose various ways to grow, achieve goals, and achieve organizational success. These methods require innovations that are continuously developed to have a positive impact and contribute to the organization as a whole. Innovation then provides opportunities for products and services offered by organizations to overgrow, even providing opportunities for companies to develop businesses with a broader reach and in a relatively shorter time. Evidence of this hypothesis is from a survey by The Boston Consulting Group (2015) in which more than 79 percent of company owners provide information that innovation is one of the top priorities for growth.

Innovation keeps the business relevant. With today's technological disruption, business changes occur all the time and very quickly, as indicated by the fast growth of new businesses, including startup businesses that are trying to change behavior and business processes. Therefore, to keep today's business relevant, adaptability is necessary.

Innovation is a way to make it easier for a company to adapt to the conditions approaching the organization so that the organization can compete and be relevant in a constantly changing environment.

Innovation is a determinant of creating distinctive characteristics of products and services created by business organizations, even becoming a corporate identity [15]. Innovation can create something different from products that function similarly to competitors in the same field. Innovation will give products and services a unique advantage, a differentiator in the market. If innovation is carried out in the work system, it will result in savings in company resources and become a business determinant to be superior.

3. RESEARCH METHODS

The focus of this paper is to see how well innovation can affect the growth of Islamic banking in Pakistan and Indonesia. So, this research adopts mixed quantitative-qualitative methods to get essential findings. Researchers seek to know the need for innovation to build growth—this research uses data from Pakistan and the Indonesian bank database. The specific method used in this study is a quantitative approach developed with a literature study approach. Hypothesis decisions are obtained by comparing the data generated by all information about Islamic banking in Pakistan and Indonesia, as Irimias & Pop (2022) did in their comparison research, at the same time [22]. The data was then used as a statistical descriptive to explore the data [25] or by presenting data from both descriptions [9].

4. RESULTS AND DISCUSSION

Based on data from the 2020 World Population Review, Islam ranks second after Christianity, with the most significant number of adherents worldwide, which is 1.91 billion. Indonesia and Pakistan are ranked first and second with the largest Muslim population. Indonesia has 231 million followers of Islam, and Pakistan has 212 million people. This substantial population should create a potential world market share, especially for Islamic banking development. At the end of 2020, Indonesia had registered 15 Islamic Commercial Banks, including 20 Islamic Business Units, and 163 Islamic Rural Banks, as shown in table 1:

Table 1. Distribution of Islamic Banking in Indonesia 2020

No	Type	Total	Number of Business Offices		
			Branches	Sub-branches	Cash Office
1	Islamic Commercial Bank	15	500	1.337	195
2	Islamic Business Unit	20	168	171	72
3	Islamic Rural Bank	163	192	-	306
			860	1.508	573
			2.941 Business Office		

Source: OJK SPS Statistics Data, 2021

For almost 30 years since Bank Muamalat Indonesia operated in 1992, the market share of Islamic banking nationally reached 6.59% of the national banking market in early 2021 despite having managed to get out of the five percent trap (OJK, 2021). The increase of almost 2% was due to the merger of 3 national Islamic banks owned by state-owned banks (BRI Syariah, Bank Syariah Mandiri, and BNI Syariah) and the existence of several regional conventional banks that converted into Islamic banks (Bank Sumut and Bank NTB). The last position shows positive numbers, where in mid-2022, the market

share of Islamic banks increased to 10.41%. Until May 2022, the total assets of Islamic banks in Indonesia reached 680.09 trillion [2].

Steps for the Islamization of the banking and financial system of Pakistan were started in 1977-78. Pakistan was among the three countries in the world trying to implement interest-free banking at a comprehensive/national level. The legal framework of Pakistan's financial and corporate system was amended on June 26, 1980, to permit the issuance of a new interest-free instrument of corporate financing named the Participation Term Certificate (PTC). Separate Interest-free counters started operating in all the nationalized commercial banks and one foreign bank (Bank of Oman) on January 1, 1981, to mobilize deposits on a profit and loss-sharing basis. From July 1, 1985, all commercial banking in Pak Rupees was made interest-free. From that date, no bank in Pakistan was allowed to accept any interest-bearing deposits, and all existing deposits in a bank were treated to be based on profit and loss sharing.

The State Bank issued detailed criteria in December 2001 for establishing full-fledged Islamic commercial banks in the private sector. Al Meezan Investment Bank received the first Islamic commercial banking license from SBP in January 2002, and Meezan Bank Limited (MBL) commenced full-fledged commercial banking operations on March 20, 2002. Further, all formalities relating to the acquisition of Societe Generale, Pakistan, by the MBL were completed. By June 2002, it had a network of 5 branches all over the country, three in Karachi, one in Islamabad, and one in Lahore.

At the end of December 2020, the composition of the Islamic banking industry remained the same, with 22 Islamic banking institutions comprising five full-fledged Islamic banks (IBs) and 17 conventional banks having standalone Islamic banking branches (IBB's). The branch network of IBI saw a quarterly expansion of 153 branches and increased from 3,303 branches to 3,456 branches (spread across 124 districts). During the year, 230 branches were added to the branch network. The region-wise concentration of branches is in Punjab, followed by Sindh and Khyber-Pakhtunkhwa. During the last quarter, 252 new windows were added to the network of Islamic banking windows (dedicated counters at conventional branches) operated by banks with IBB's. They reached 1,638 Islamic banking windows by the end of December 2020.

Table 2. Distribution of Islamic Banking in Pakistan 2020

No	Type of Islamic Banking	Total	Branch
1	Islamic Commercial Bank (IB)	5	3456
2	Islamic Banking Branch (IBB's)	17	
3	Islamic Window Branch	-	1638
			5094

Source: SPB Statistics Data, 2020

The Islamic banking system in Pakistan has reached 44 years, much longer than the age of Islamic banks in Indonesia. The operation of private Islamic banks in Pakistan, which reached 19 years in 2020, has recorded a market share of 15.3% (19.5% on June 2022). This condition invalidates the assumption that a large (homogeneous) population will win the market competition. This assumption by Kaid (2018) is often found in presidential election competitions or political parties, with many people who will be able to seize power. In addition, this condition also concludes that the development of Islamic banks in Indonesia and Pakistan is still low but still has the opportunity to seize a larger market share.

Answering the current paradigm takes work. The history of Islamic banks in these two countries has given considerable effort to win the competition. Khan & Batti, in

2006, had information that they have made promotional efforts to penetrate the market, evaluate and determine products that can be sold to consumers, and improve services to consumers, even the government supports by making special regulations or legislation for Islamic banks. The Indonesian government even converted conventional banks into Islamic banks and merged the three biggest ones to increase this market share. However, if we look at the percentage of market share owned by Islamic Banks in Indonesia and Pakistan, the efforts made so far have not been maximized.

Several assumptions cause this condition to occur. The first is the assumption that consumers have yet to receive accurate information regarding the differences between Islamic and conventional banks, especially regarding their products and services. Even consumers can state that there is no difference. The second assumption is that the products offered by Islamic banks are similar to conventional banks in terms of price, convenience, and innovation. Third, the ease of obtaining and using bank services or products, both from digital services and the number of ATMs or offices (Syafrida & Aminah, 2015), and maybe there are many other factors assumed. Based on these facts and assumptions, Islamic banks need innovation in every process to gain a larger market share.

5. CONCLUSIONS

This paper describes how the Indonesian Islamic Bank had more growth than the Pakistan Islamic Bank, even though the Pakistan Islamic Bank has been in operation for much longer. There are several reasons for these findings, including the population and distribution of Indonesia's territory, which is much larger than Pakistan. However, today's banking challenges are more widely accepted by Indonesian Islamic banking, where technological factors heavily influence growth. Therefore, growth occurs by adapting innovations in banking organizations in Indonesia. Innovation is carried out by applying technology in banking business processes and strategic actions, such as the merger of Islamic banks to form the strength of Indonesia's most prominent Islamic bank.

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