

THE ROLE OF INCLUSIVE FINANCE IN REDUCING POVERTY: A COMPARISON OF TRADITIONAL AND SHARIA LOAN MODELS

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ABSTRACT

This study compares conventional and Sharia lending strategies to evaluate inclusive finance's poverty reduction potential. The method uses literature, case studies, and data on sharia and conventional finance, microfinance, SMEs, and related issues. Gap analysis examines pre- and post-loan financial access, corporate sustainability, and poverty levels. The study found that profit-sharing and interest-free sharia loans help small and micro companies in unstable economic times. Sharia borrowers are more successful in maintaining and growing their businesses than traditional loans. The survey also found that Islamic loans are more likely to be used in community-beneficial industries like agriculture and infrastructure. Based on these findings, the proposals include boosting government support for sharia financial goods, producing financial products that help the productive sector, and changing policies to expand access to sharia financial services in poor areas. This study emphasises the need for an inclusive financial system focused on social goals and long-term sustainability to end global poverty.

Keywords: Conventional and Sharia Loans, Inclusive Financing, Poverty Reduction, Small and Micro Enterprises

INTRODUCTION

It is commonly acknowledged that inclusive finance is an essential tool for international efforts to reduce poverty (Gálvez-Sánchez et al., 2021; Jia et al., 2021). It has been demonstrated that having access to financial services like insurance, loans, and savings affects a person's or family's capacity to reinvest in and develop economic prospects. Nonetheless, there is still disagreement regarding the best financial services strategy to promote the fight against poverty. Specifically, the distinctions between sharia-compliant and conventional lending methods present several angles on inclusive financial strategies (Bizri et al., 2018; Kunhibava et al., 2024). The interest structures of conventional lending models, which are prevalent in many international financial markets, are frequently criticized for placing undue stress on already vulnerable borrowers (Buckland & Buckland, 2018b, 2018a) However, for people in underprivileged communities, Islamic financing arrangements, which forgo interest due to religious beliefs, offer a more equitable and possibly long-term solution. Nevertheless, despite the Islamic banking sector's explosive expansion, little is known about its actual efficacy in reducing poverty, particularly when

compared to more established methods (Iman, 2020; Shofawati, 2023). Prior research has primarily focused on quantitative analysis of the financial results of persons utilizing these services (Fanta & Mutsonziwa, 2021; Fernández-Olit et al., 2020; Mohan et al., 2024) However, there is a lack of comprehensive literature that thoroughly investigates the mechanisms, reasons, and circumstances under which these models function effectively in various situations. There is a scarcity of research that explicitly compare the two models under similar market settings to comprehensively grasp their respective strengths and limits in their impact on poverty alleviation. This article emphasizes the significance of financial inclusion as a means of alleviating poverty, specifically by comparing conventional and sharia lending approaches. The purpose of this paper is to assess the effectiveness of these two lending strategies in achieving these goals. This article utilizes gap analysis to identify disparities in performance and social impact between the two models. Sharia lending approaches, rooted on values of equity and collaboration, are frequently regarded as more attuned to the need of underprivileged communities in contrast to profit-driven conventional models (Bolo, 2020). The significance of this study resides in its contribution to a more profound comprehension of how diverse financial methodologies can impact poverty reduction and enhance financial inclusion. Ultimately, this study aids policymakers and financial institutions in devising more efficient and enduring strategies. This paper aims to address this deficiency by conducting a comparative analysis of the efficacy of conventional and sharia lending models. The analysis will be based on existing literature data and pertinent case studies. This literature review aims to offer a comprehensive understanding of how inclusive finance can be effectively constructed to optimize its positive influence on poverty alleviation, taking into account local requirements and circumstances.

METHOD

This essay employs a methodology that involves comparing conventional and sharia lending models in order to mitigate poverty. This study utilized a comparative research methodology. This study assesses the efficacy of conventional and sharia financial models in alleviating poverty in multiple developing nations. This study employs a comprehensive approach that includes a review and evaluation of literature, case studies, and data analysis to examine the impact of inclusive finance and sharia finance on poverty reduction. Borrowers adhering to the sharia model have a superior level of performance in sustaining and advancing their enterprises in comparison to borrowers following the traditional model. The literary sources utilized pertain to sharia banking and microfinance, specifically targeting small and micro business groups in their company management endeavors. The methodology involves doing a comprehensive analysis of scholarly research pertaining to sharia banks, sharia institutions, the Financial Services Authority (OJK), their affiliations, as well as other sources that examine microfinance and its associated concerns. The literature materials utilized encompass both domestic and global perspectives pertaining to the topic under consideration. This includes governmental measures that provide support for agricultural projects and initiatives aimed at alleviating poverty. In addition to that, the approach used to analyze this study involves reviewing literature, case studies, and relevant information on sharia lending and innovation.

RESULTS**Basic Principles of Conventional and Sharia Finance**

The activities of global financial institutions are supported by two distinct systems: conventional finance and Islamic finance (M. K. Hassan, Khan, et al., 2021; Hidayat et al., 2021). Each of these systems is characterized by its own set of principles and practices. Banks and other financial institutions are able to create profits through the interest that they charge on loans thanks to conventional finance, which is founded on the idea of interest. This approach is frequently criticized due to the fact that it has the potential to make things more difficult for borrowers, particularly in economic situations that are shaky. On the other hand, Islamic finance is governed by Islamic law, which forbids the use of interest in financial transactions. In this system, the concept of profit sharing or joint profits is used in place of interest. This means that the bank and its customers share the risks and gains that are associated with investments or financial transactions. The concepts of openness and fairness not only provide an option that adheres to ethical standards, but they also appeal to individuals who are not Muslims and are looking for ethical and sustainable financial practices (Iqbal et al., 2017; Izhar & Kasri, 2021). Due to the fact that these two systems provide distinct viewpoints on financial management and investments, they provide individuals and organizations with the opportunity to manage their resources in accordance with their own personal values and requirements (Ahmed & Salleh, 2016; Joniaková & Blštáková, 2015; Reina & Scarozza, 2021). Traditional and Sharia finance are two financial systems that form the foundation of many modern financial institutions (Altwijry et al., 2022; A. Hassan et al., 2022). However, these two approaches follow completely distinct concepts. In conventional finance, the concept of interest is central to all transactions. Financial organizations make money by charging interest on loans and paying interest to depositors, based on a long-standing risk and reward paradigm. Although this system is effective at allocating capital and promoting economic activity, it is sometimes criticized for exacerbating inequality and burdening borrowers with interest payments, particularly in poor economic conditions. In contrast, Islamic finance functions on principles that are consistent with Islamic law, which forbids the practice of giving or receiving interest (M. K. Hassan, Muneeza, et al., 2021). The three major concepts of Islamic finance are *mudarabah* (profit collaboration), *murabaha* (profit selling), and *ijarah* (lease). Islamic finance emphasizes asset-based or real-world transactions in which the source and recipient of funds share the risks and gains of the investment. This not only fosters fairer and more transparent procedures, but also inhibits excessive speculation in order to ensure stability and more sustainable economic growth. A basic gap between the two approaches to ethics and financial conduct is reflected in these key disparities. In contrast to Islamic finance, which places an emphasis on justice, the avoidance of excessive risk, and compliance with ethical values, conventional finance is primarily concerned with the maximization of profits and the efficiency of the market (Alhammedi, 2024; Moghul & Moghul, 2017). Consequently, these two systems offer distinct frameworks that individuals and organizations might utilize in order to handle the financial aspects of the institution. The advantages that each of these institutions provides are tailored to meet the diverse requirements and ethical convictions of their customers.

DISCUSSION

Performance Analysis of Conventional Loan Models

In the context of inclusive finance, an analysis of the performance of conventional lending models reveals a number of dynamics that affect the effectiveness of these models in reducing poverty and broadening access to financial resources. Historically, this model has been the dominant force in global financial markets, and it has been responsible for providing capital for both consumption and investment. Its primary characteristic is the provision of credit based on interest obligations. The accessibility of services, the conditions of loans, the economic impact on borrowers, the percentage of borrowers who fail to repay their loans, and the level of pleasure experienced by borrowers are the primary focuses of this analysis. The ease with which low-income groups can obtain loans, the fairness of loan conditions such as interest rates and repayment terms, and the direct impact that loans have on enhancing the quality of life of the borrower are all aspects that will be evaluated as part of this study. Additionally, the analysis is critical of the default rate as a measure of risk and model success in credit management. This is in addition to the previous criticism. After that, the responses of borrowers, which are gathered through surveys, offer an understanding of the level of satisfaction that customers have with the services that are offered. The results of this analysis provide a detailed insight into the successes and possible areas for improvement in traditional lending models, illustrating the significance of these models in the context of initiatives aimed at achieving financial inclusion. There are a number of benefits and drawbacks associated with conventional lending models that should be taken into consideration while conducting performance analysis. The capability of the model to deliver a consistent and trustworthy evaluation of creditworthiness on the basis of significant historical data is one of the aspects that contribute to its advantages. The ability to decrease credit risk in a manner that is both structured and measurable is made possible for banks and other financial organizations by this. Additionally, conventional lending methods are frequently supported by preexisting regulations and standards, which makes it simpler to incorporate them into preexisting financial policies and procedures. On the other hand, there are a number of disadvantages that cannot be overlooked. One of the many characteristics of this conventional approach is that it can be rigid and inflexible, and it frequently lacks the ability to quickly adjust to shifting market conditions or new financial advances. Furthermore, these models might not be adequate when it comes to evaluating non-traditional borrowers or those who do not have significant credit histories. Additionally, this might result in the denial of credit to persons or enterprises who would otherwise be qualified for it. In addition, the fact that these models are dependent on historical data may lessen their effectiveness in dealing with unanticipated financial crises. This is because these models have a tendency to repeat assumptions from the past that may no longer be applicable.

Evaluation of the Effectiveness of Sharia Loans

The socioeconomic effect of the product and the tenets of Islamic finance are reflected in the several crucial elements of the evaluation of the effectiveness of Islamic loans. An ethical and maybe more equitable substitute for traditional loans are Islamic loans, which forego interest and give priority to profit-sharing arrangements. Among the advantages of sharia loans are that their efficacy is frequently determined by their adherence to sharia principles, which forbid usury (interest), gharar (uncertainty), and maysir

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(speculation). This guarantees the fair and transparent execution of every transaction. The way sharia loans handle risk and income through agreements like *musharakah* (cooperation), *mudharabah* (profit sharing), and *murabahah* (selling of profits) is also taken into account. Other advantages of evaluation include the social impact of sharia loans, particularly in terms of encouraging inclusive economic development. This is in addition to the aforementioned advantages. In many cases, the purpose of these goods is to provide assistance to small and medium-sized businesses (SMEs), as well as to projects that offer social advantages, such as agriculture and affordable housing. One of the most crucial criteria for determining whether or not Islamic loans are beneficial is whether or not they are successful in expanding access to financial resources for communities that are either unserved or underserved. In terms of the level of financial literacy in Indonesian society, the findings of the survey indicate a substantial rise in the level of financial literacy. A person's financial attitudes and behaviors can be influenced by their knowledge, abilities, and beliefs, which are collectively referred to as financial literacy. The goal of financial literacy is to improve the quality of decision making and financial management in order to achieve prosperity (OJK, 2022). According to the findings of a survey performed by the Financial Services Authority (OJK), there has been a notable rise in financial literacy among the general population of Indonesia on an annual basis. This demonstrates that individuals possess increasingly profound aspirations concerning their understanding and knowledge of financial matters as time progresses.

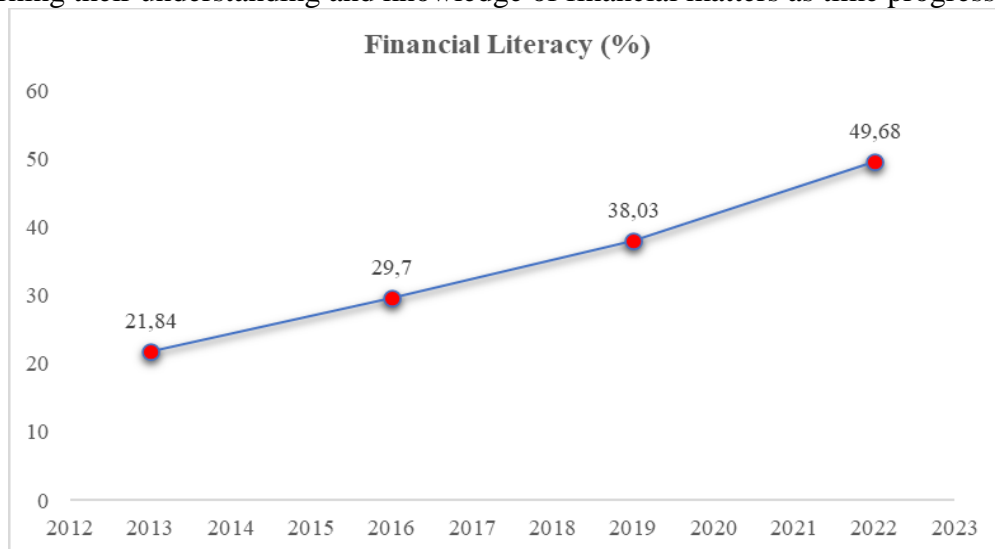


Figure 1. Indonesian financial literacy index

Source: (OJK, 2022)

In addition to this, the availability of access for the community to utilize financial products and services in formal financial institutions in line with the requirements and capabilities of the community in order to realize their prosperity is a component that is associated with the concept of financial inclusion (OJK, 2022). According to the OJS data, there has been a notable rise in the level of financial inclusion among society. This demonstrates that the general public possesses a heightened understanding of financial inclusion, which is connected to their aspiration to enhance the overall well-being of society.

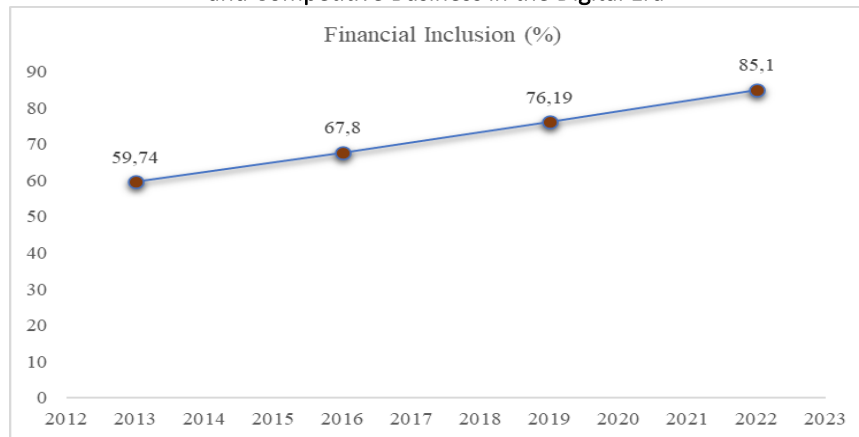


Figure 2. Financial Inclusion Index

Source: (OJK, 2022)

The efficacy of Islamic loans is also impacted by their capacity to create substantial returns for investors and ensure financial stability for the financial institutions that provide them. In Islamic lending, alternative income structures must possess sufficient strength to cover operational costs and credit concerns, while also offering competitive returns to investors, even when interest is avoided. Additionally, the study also examined the incorporation of the most recent financial technology to enhance service and accessibility in sharia loan products, with a particular focus on adaptation and innovation. The utilization of fintech to broaden the range and enhance the effectiveness of Islamic financing, while also adjusting items to address swiftly evolving market demands, serves as a significant measure of the advancement and significance of Islamic finance in the contemporary day. Moreover, the evaluation of the efficacy of sharia loans entails appraising their adherence to sharia principles, their social impact in promoting inclusive economic growth, their capacity to generate consistent profits for investors, and their adaptability and innovation in incorporating financial technology. Sharia loans give a morally upright and equitable option by circumventing the charging of interest and promoting initiatives that yield societal advantages. They also assess the competence of financial institutions in handling risks and profits through profit sharing arrangements and transactions based on principles of justice.

Case Studies and Practical Applications

In understanding the richness and complexity of Islamic finance, case studies and practical applications are critical in demonstrating how Islamic principles are applied in ordinary economic activity. This technique allows us to obtain a thorough understanding of the practical application of Islamic finance theory and its impact on corporate success and community welfare. In the field of Islamic finance, case studies and practical applications are frequently used to demonstrate how Islamic principles are applied to financial products and services. This case study focuses on a sharia bank that offers murabahah funding to small and medium-sized firms (SMEs). Murabahah is a sales and purchase agreement in which a bank buys items and sells them to consumers at a price that includes an agreed-upon profit margin. In this scenario, a small and medium-sized enterprise in the agriculture industry requires finance to purchase agricultural equipment. Sharia banks buy the equipment and

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resale it to SMEs at a 10% profit margin, which is paid back within 12 months. The efficacy of this application is evidenced by the capacity of small and medium-sized enterprises (SMEs) to enhance their output and fulfill heightened market requirements. Furthermore, this transaction enables small and medium-sized enterprises (SMEs) to circumvent loan interest, adhere to sharia principles, and access equitable and transparent financing alternatives. Another practical use is the mudharabah initiative, which involves investment collaboration between sharia banks and renewable energy enterprises. Under this arrangement, Islamic banks serve as rabb-ul-mal, providing funds as capital owners, while energy corporations assume the role of mudharibs, acting as project managers. The funds are allocated towards constructing a solar panel installation within a nearby community. The project's profits are allocated based on a predetermined ratio, such as 60% for the bank and 40% for the energy business. This initiative not only yields a favorable return on investment but also promotes sustainable growth and fosters local job generation. This demonstrates the capacity of Islamic finance to bolster endeavors that yield favorable social and economic outcomes. The application of Islamic principles in real contexts is exemplified by case studies and practical applications in Islamic finance, such as mudharabah investments in renewable energy initiatives and murabah financing for small and medium enterprises. These instances demonstrate how Islamic finance promotes economic expansion, abstains from usury, and implements the principles of transparency and justice. This case study demonstrates the efficacy of Islamic finance in the development of sustainable and ethical solutions, as well as its contribution to broader social and economic development.

Comparing the Impact of Conventional and Sharia

The fundamental differences in approaches and outcomes between conventional and sharia finance are evident in a comparison of their respective impacts. Conventional finance, which is predominantly interest-based, is characterized by market mechanisms that enable rapid growth and high flexibility. Nevertheless, this system is frequently criticized for its failure to consider the social consequences and its tendency to generate economic instability, particularly when it pertains to complex financial products and speculation. In contrast, Islamic finance prioritizes mutual risk and profit, justice, and the prohibition of interest, speculation, and investment in products that are deemed immoral. This results in a positive contribution to environmental and community development, as well as increased financial stability and sustainable growth. There exist variations in the way that sharia banks and regular bank financing are implemented. A table outlining the distinctions between the two banks is provided below.

Table 1. Disparities Between Sharia and Conventional Bank Financing

No.	Conventional Banks	Sharia Bank
1.	The product does not refer to sharia compliance	Products must comply with sharia principles
2.	Profits are obtained from debt and receivable contracts	Profits obtained from commercial contracts
3.	The relationship between the parties is in the form of debtor and creditor with interest.	The relationship between the parties can be in the form of a partnership, seller and buyer, lease or debtor and creditor without interest.

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| 4. Supervision only by OJK | Supervision is carried out by OJK (Financial Services Authority) and DPS (Sharia Supervisory Board) |
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Source: (Prudential Syariah, 2022)

Regarding their respective roles, Islamic banks and conventional banks differ from one another in four ways, all of which are further detailed in the table that follows.

Table 2. Disparities between traditional banks and Sharia banks (based on bank functions)

No.	Banking functions	The function of collecting funds, distributing funds for financial services, and social functions (distributing ZIS, waqf and others)	The function of collecting funds, distributing funds and providing financial services
1.	Regulations (governing provisions)	a. Bank Indonesia Regulations (PBI) b. Financial Services Authority Regulations (POJK) a. Fatwa of the National Sharia Council (DSN)	a. Indonesian banking regulations (PBI) b. Financial Services Authority Regulations (POJK)
2.	Banking Organizational Structure	a. Sharia Supervisory Board b. Commissioner c. Directors	a. Commissioner c. Director
3.	Source of Income	Margin/profit from buying and selling transactions, profit sharing from profit sharing transactions, ujroh from ijarah transactions	Bank interest
4.	Transaction Principles	In accordance with Sharia Principles	Profitable, Prudential Banking

Source: (Prudential Syariah, 2022)

Islamic finance also provides financial support for initiatives that directly enhance social welfare, such as sustainable development and infrastructure, through a transparent and ethical financing model. This not only enhances the economy but also promotes social justice and reduced inequality in the long term.

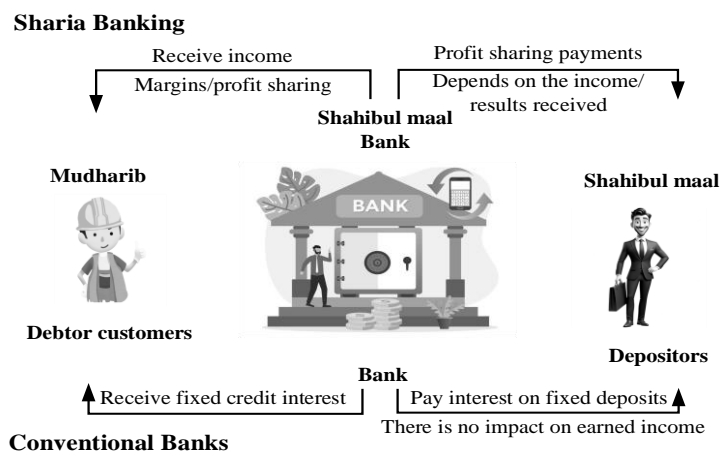


Figure 3. Bank operational scheme (Sharia Bank against Conventional Bank)

Source: (Certified Islamic Banking Course, P3EI, 2024)

Islamic finance prioritizes long-term stability and social justice, in contrast to conventional finance, which can provide high efficacy and short-term economic growth. Consequently, this comparison undoubtedly underscores the significance of selecting a financial strategy that is not only profitable but also considers the social and ethical implications of the contemporary global economy.

Challenges in Loan Model Implementation

There are many intricate obstacles to overcome in the use of loan models in both traditional and sharia financial systems. In traditional finance, managing credit risk and determining suitable interest rates are frequently the biggest obstacles. While interest rates that are too low may not accurately reflect risk and could result in financial losses for lending institutions, interest rates that are too high could make it difficult for riskier borrowers to obtain financing. For instance, poor risk assessments on subprime mortgage loans—where borrowers with poor credit ratings were issued loans assuming ever-increasing property values—led to significant losses for numerous institutions during the 2008 financial crisis. The complexity of contract structures and sharia compliance are frequently the sources of implementation challenges in Islamic finance. Sharia lending models must guarantee that all transactions are conducted within a transparent profit-sharing or buying-and-selling framework and that interest is not charged. For instance, in murabahah financing, the bank is necessitated to acquire and retain ownership of the products prior to their sale to customers at a profit. This process presents logistical challenges and necessitates rigorous verification to guarantee that transactions adhere to sharia, frequently leading to increased operational costs and a lengthier process than conventional loans. Interest rates and credit risk in conventional systems, as well as operational complexity and sharia compliance in sharia finance, are among the obstacles to the lending model's implementation. It is crucial for financial institutions to take into account the unique approach of each system in addressing these challenges when developing secure and effective loan products.

Optimization Strategy for Inclusive Finance

The objective of optimization strategies for financial inclusion is to increase the availability of financial services to marginalized populations, which are frequently disregarded by conventional financial systems. One of the primary strategies is the utilization of financial technology, or fintech, which can reduce access disparities by offering financial services through digital platforms. As an illustration, mobile banking and digital payment applications facilitate financial transactions in remote regions without necessitating visiting a bank branch. The M-Pesa service in Kenya has effectively integrated millions of users into the financial ecosystem by offering money transfer and payment services via mobile phones. The development of products that are specifically tailored to suit the needs of marginalized groups is also significant. For instance, banks in India provide customized microloans to women, farmers, and small entrepreneurs in rural areas, frequently with more accommodating terms than conventional loans. This approach not only enhances financial accessibility but also contributes to the growth of the local economy. To attract a wider audience, commercial banks might also form agreements with non-profits or microfinance institutions. The partnership between Citibank and Grameen Bank, which assists in giving

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small loans to microentrepreneurs in Bangladesh, is one illustration of this. Through this collaboration, Citibank may increase its market share while lowering risk, and Grameen Bank can access more capital sources. The development of financial products specifically aimed at underrepresented communities, the use of technology to improve accessibility, and strategic alliances between major and small financial institutions are all examples of inclusive finance optimization techniques. By using this strategy, inclusive finance can improve overall economic development and lessen economic inequality.

CONCLUSION

To achieve a more equitable society and a more inclusive economy, several measures must be implemented, particularly by policymakers. In this scenario, policymakers are confronted with the formidable task of incorporating financial methods that can enhance the availability of financial services for individuals across all socioeconomic strata. The success of this project would not only enhance economic fundamentals but also lead to significant social change. Policy makers should consider several ideas to enhance the accessibility and efficacy of financial services across all segments of society in the context of inclusive finance. According to the analysis of the optimization strategy, there are several crucial recommendations. One of them is the necessity to adopt and integrate fintech, where policymakers should actively promote and support the use of innovative financial technology. This might involve offering incentives for the creation of mobile banking applications that can be used in remote regions, as well as digital payment platforms to streamline financial transactions. In addition, it is necessary to create tailored goods that can incentivize financial institutions to design products that cater to the need of excluded populations. These encompass financial products including microloans, insurance, and savings accounts that are tailor-made for farmers, small business owners, and individuals with low incomes. Furthermore, there is a necessity for the establishment of strategic alliances, as this strategy can facilitate the development of a policy framework that fosters collaborations between conventional financial institutions and microfinancers. These collaborations should focus on expanding financial access and distributing risk, while offering incentives to major financial institutions to invest in projects that have a social benefit. Moreover, it is imperative to establish policies that promote and facilitate financial inclusion. Enforcing these standards can facilitate innovation while guaranteeing consumer safety. This involves streamlining the licensing requirements for new financial institutions that aim to provide digital financial services and implementing rigorous information security standards. Hence, it is imperative for policy makers to ensure that financial inclusion not only facilitates economic expansion but also guarantees that the advantages of this expansion are experienced by all strata of society. These proposals are expected to meet financial policies that are comprehensive, sustainable, and adaptable to the requirements of a changing society.

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