

## **INNOVATION AND CHALLENGES IN SHARIA FINANCIAL SERVICES FOR MICRO, SMALL AND MEDIUM ENTERPRISES**

**Hari Akbar<sup>1</sup>, Cut Rusmina<sup>2\*</sup>, Radhiana<sup>3</sup>, Putri Mauliza<sup>4</sup>, Aisyah Nahya<sup>5</sup>**

<sup>2</sup>Accounting Department Accounting Universitas Serambi Mekkah

<sup>3,4</sup>Management Department Universitas Serambi Mekkah

<sup>1,5</sup>Student Accounting Department Universitas Serambi Mekkah

Jl. Tgk. Imuem Lueng Bata, Suka Damai, Banda Aceh - 23245

\*Email: [cut.rusmina@serambimekkah.ac.id](mailto:cut.rusmina@serambimekkah.ac.id)

### **ABSTRACT**

The purpose of this research is to investigate the creative ways and challenges associated with offering Sharia-compliant financial services to Micro, Small, and Medium Enterprises (MSMEs). Using a comprehensive literature review methodology, the article evaluates existing research, case studies, and industry reports to identify major advances and ongoing barriers in this field. The findings show substantial advances in ethical finance, risk-sharing systems, and interest-free models that adhere to Sharia standards. However, the study also reveals important gaps, such as legislative impediments, MSMEs' lack of awareness and comprehension of Sharia financial products, and the need for financial institutions to enhance their competence. The gap analysis emphasizes the importance of policy reforms, specific educational programs, and strategic alliances to address these difficulties. This article emphasizes the potential of Sharia financial services to promote a sustainable and equitable financial environment for MSMEs, assuming that these deficiencies are addressed via collaborative efforts by all stakeholders.

**Keywords:** Ethical Finance, Financial Services, Ongoing Barriers, Risk-sharing Systems

### **INTRODUCTION**

Indonesia's Sharia-compliant financial sector is a unique model that integrates traditional Islamic principles with contemporary financial requirements, thereby considerably influencing the local economy by providing support to micro, small, and medium enterprises (MSMEs) (Kamaly et al., 2022; Pitaloka et al., n.d.). This sector operates within a distinctive framework that prohibits speculative activities (gharar) and interest (riba), instead emphasizing profit-sharing and risk-sharing arrangements that are consistent with Islamic law (Benaicha, 2020; Jaafar & Brightman, 2022). This model advocates for ethical investing and financing practices that are appealing to a diverse audience, not limited to those who adhere to Islamic principles (Asari, 2024a, 2024b). It is evident that Sharia-compliant micro financing plays a critical role in Indonesia by providing capital to MSMEs, which frequently lack access to traditional banking services due to their inability to meet stringent collateral requirements or their avoidance of interest-based financial products for

## Proceeding 2<sup>nd</sup> Medan International Economics and Business

Volume 2, Issue 1, 2024

“Human Resource Transformation and Collaborative Innovation to Build Independent and Competitive Business in the Digital Era”

religious reasons. Sharia financial services have developed innovative products such as Murabaha (cost-plus financing) and Mudarabah (profit-sharing investment) that offer essential liquidity to MSMEs while adhering to Islamic law (Hanif & Ayub, 2022; Sari et al., 2024). This not only promotes business expansion but also cultivates a more inclusive financial system that integrates underserved sectors into the mainstream economy (Kandpal et al., 2023; van Niekerk, 2024). Furthermore, the influence of these services is exacerbated by the sizeable Muslim population that exists in Indonesia, which makes the country an ideal environment for the development and innovation of Sharia finance. For example, several Sharia banks have adopted digital technology in order to expand their reach into rural areas, which are typically underserved by traditional banks. This has resulted in the democratization of individuals' access to financial resources. It is now much simpler for micro, small, and medium-sized enterprises (MSMEs) to acquire financial services in a timely manner thanks to the utilization of digital platforms and mobile banking, which has not only increased the accessibility of Sharia-compliant financial services but also improved their efficiency. In conclusion, the incorporation of Islamic concepts into microfinancing within Indonesia's financial sector that is in compliance with Sharia has shown to be an essential enabler for the expansion and support of micro, small, and medium-sized enterprises (MSMEs). This sector not only adheres to ethical norms that are shared by a significant portion of the Indonesian community, but it also answers the actual economic demands of emerging and small-scale firms, making a significant contribution to the economic diversity and resilience of the country.

### METHOD

The approach employed in this study is a comprehensive examination of articles sourced from literature studies on the obstacles and advancements in Islamic finance programs for micro, small, and medium companies (MSMEs), along with academic and related literature. This article employs a thorough examination of literature to assess current research, case studies, and industry reports in order to identify significant progress and persistent obstacles in this subject. Gap analysis highlights the significance of implementing policy changes, developing specialized education programs, and forming strategic partnerships in order to address and overcome these challenges. The literature materials utilized encompass both domestic and foreign references, specifically focusing on topics such as Microfinance, MSMEs, Islamic financial associations, and other relevant subjects. Furthermore, the methodology employed in this research entails a comprehensive review of existing literature, an in-depth analysis of case studies, and the utilization of data pertaining to Islamic financing schemes and associated subjects.

### RESULTS

#### Innovative Sharia Financial Products for MSMEs

The development and implementation of cutting-edge financial products within Indonesia's Sharia-compliant sector demonstrate a sophisticated blend of adherence to Islamic principles and a keen responsiveness to the specific needs of micro, small, and medium enterprises (MSMEs) (Agrawal, 2016; HUMAN-CENTRICITY & ASIA, 2024). For example, Bank Syariah Indonesia (BSI) has pioneered a range of innovative financial

products that exemplify this blend, such as their Sharia-compliant supply chain financing, which facilitates transactions between MSMEs and their suppliers under Islamic contracts like Murabaha and Musharakah. These contracts not only ensure compliance with Islamic law by avoiding interest and emphasizing risk-sharing, but also enhance business liquidity and operational capacity. Another innovative product is the “Green Financing” initiative, aimed at promoting environmental sustainability (Dovidonis, 2024; Ma et al., 2023). This product supports MSMEs in sectors like renewable energy and waste management, aligning with the Islamic principle of stewardship of the earth (Khalifah) and demonstrating how Sharia finance can contribute to broader socio-economic goals beyond immediate financial needs (Abbas et al., 2023). Furthermore, the use of digital platforms by institutions like BSI has revolutionized access to these innovative products (Caniago, 2023; Verdianti et al., 2024). By leveraging fintech, these banks can offer seamless and efficient services such as real-time payment processing and electronic documentation, crucial for MSMEs needing to manage their operations without the delays typical of traditional banking. For instance, the digital murabahah platform allows MSMEs to apply for, receive, and manage their financing completely online, reducing the processing time and making Islamic financing more competitive. These examples highlight how the Sharia-compliant financial sector in Indonesia is not just adhering to Islamic principles but is actively using them as a foundation for innovation in financial products. This approach has opened new avenues for business growth and sustainability for MSMEs, providing them with the tools to compete effectively in both local and global markets while maintaining ethical and sustainable business practices.

### **Regulatory Framework and Compliance Challenges**

The regulatory environment in Indonesia poses unique challenges for financial institutions operating within the Sharia-compliant framework, as they strive to innovate while maintaining strict adherence to Islamic laws. This balance is critical because any deviation from Sharia principles can lead to the withdrawal of patronage by religiously observant customers, while a lack of innovation may render these institutions non-competitive against conventional banks. One significant challenge is the dynamic nature of Sharia interpretation, which can vary widely among Islamic scholars and regulatory bodies. This variability can lead to inconsistencies in product offerings and confusion among consumers about what truly constitutes a Sharia-compliant product. Based on the role and contribution of MSMEs, it is evident that they play a crucial role in supporting the development of the national economy. Micro, Small, and Medium Enterprises (MSMEs) have a significant impact on Indonesia's economy, accounting for 60.51% of the country's overall Gross Domestic Product (GDP). In addition, MSMEs in Indonesia employ around 117 million workers, accounting for approximately 97% of the country's workforce (OJK, 2021b). There are over 64 million micro, small, and medium enterprises (MSMEs) in Indonesia, accounting for almost 99.99% of all business entities in the country. MSMEs generate approximately 15.7% of Indonesia's overall non-oil and gas exports. For instance, the introduction of digital financial services has necessitated new rulings (fatwas) from the Indonesian Ulema Council (MUI), the authoritative body that certifies products as Sharia-compliant (Muryanto, 2023; Setiawan, n.d.). The development of digital murabahah (cost-plus financing) platforms, while increasing accessibility and efficiency, required extensive

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## Proceeding 2<sup>nd</sup> Medan International Economics and Business

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Volume 2, Issue 1, 2024

“Human Resource Transformation and Collaborative Innovation to Build Independent and Competitive Business in the Digital Era”

review to ensure transactions did not violate the prohibition against riba (interest) and were structured to include all elements of a valid Islamic contract. Moreover, the integration of international financial standards with local Sharia practices also presents challenges. For example, when Bank Syariah Indonesia (BSI) was formed by merging several smaller Islamic banks to create a more robust and competitive institution, the regulatory oversight had to ensure that all integrated operations harmonized not just with Indonesian law but also with international best practices for Islamic finance, which are still in development and subject to debate. The situation is further complicated by the need for continual education and training for regulators and practitioners to keep pace with both financial innovations and evolving interpretations of Sharia. This scenario underscores the delicate act of balancing between adherence to traditional Islamic values and the adoption of modern financial practices, necessary for expanding the reach and improving the services of Sharia-compliant financial institutions in Indonesia.

### DISCUSSION

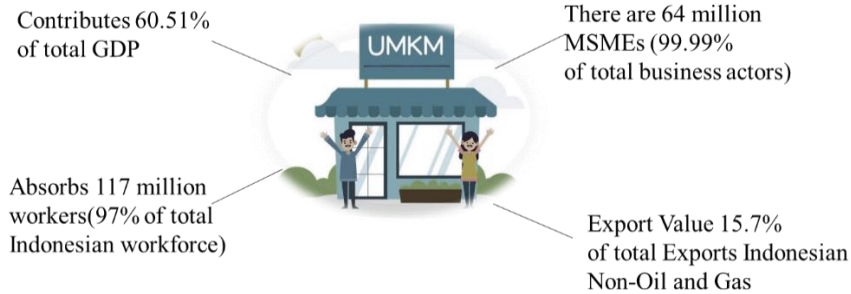
#### Results and Insights from Real-World Case Studies

The incorporation of Sharia financial services into micro, small, and medium enterprises (MSMEs) in Indonesia has demonstrated diverse achievements, offering valuable insights and efficient approaches for wider implementation. An example of this is the situation of a furniture manufacturing company on a small scale in Jepara, Central Java, which illustrates the advantages of financing that adheres to Sharia principles. Facing initial financial constraints in acquiring raw materials, the company successfully obtained a Murabaha financing deal from a nearby Islamic bank. By adhering to Sharia standards, they were able to purchase wood in large quantities directly from suppliers at a pre-determined price that included a profit margin for the bank but did not include any interest. The company's ability to anticipate and plan for costs allowed it to efficiently handle its finances and grow its manufacturing capabilities. Another notable example is a tiny fashion business in Bandung that employed a Musharakah mutanaqisah partnership, a type of declining partnership, with a Sharia bank. This product facilitated the progressive acquisition of the bank's stake in the company, promoting ownership and investment in accordance with Islamic law. The startup received financial assistance from the bank while maintaining its adherence to Sharia principles, resulting in a wider market reach and enhanced brand visibility among Muslim consumers in Indonesia. There are over 64 million micro, small, and medium enterprises (MSMEs) in Indonesia, accounting for almost 99.99% of all business entities in the country. MSMEs generate approximately 15.7% of Indonesia's overall non-oil and gas exports.

# Proceeding 2<sup>nd</sup> Medan International Economics and Business

Volume 2, Issue 1, 2024

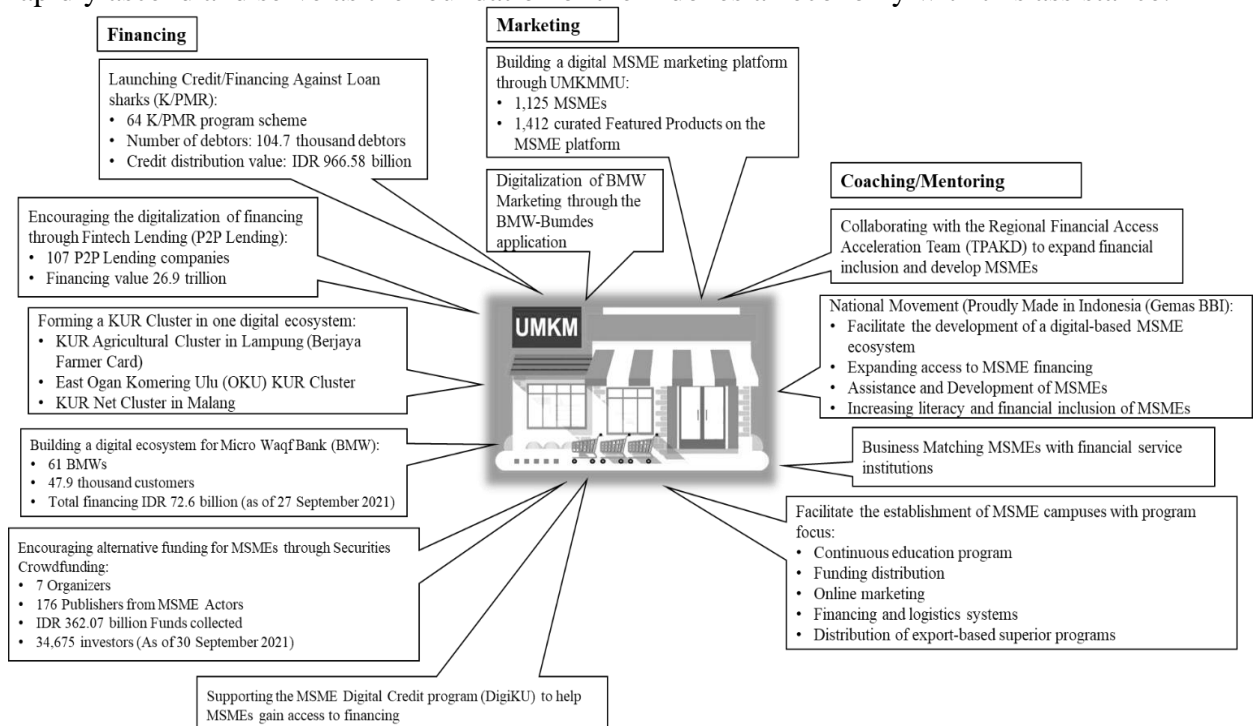
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**Figure 1.** MSMEs’ Contribution to the Indonesian Economy

Source: (OJK, 2021b)

As another example, there are activities that can be viewed from a sharia perspective in terms of innovation and expansion. As an illustration of the Financial Services Authority's (OJK) programme innovation. OJK is dedicated to the promotion of the growth of MSMEs by implementing a variety of policies, such as the digitalisation of financing distribution. For this reason, it operates programmes. OJK also advocates for the extension of the integrated MSME digital ecosystem from upstream to downstream. This encompasses the digitalisation of basic material procurement, production processes, marketing both domestically and internationally, and financial support. OJK and the financial services industry also conduct a variety of coaching and mentoring activities for MSMEs. It is anticipated that MSMEs will rapidly ascend and serve as the foundation of the Indonesian economy with this assistance.



**Figure 2.** OJK Support for MSME Development

Source: (OJK, 2021a)

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## Proceeding 2<sup>nd</sup> Medan International Economics and Business

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Volume 2, Issue 1, 2024

“Human Resource Transformation and Collaborative Innovation to Build Independent and Competitive Business in the Digital Era”

Several crucial lessons can be derived from these case studies. Sharia financial products can improve the financial stability and growth prospects of MSMEs by being adaptable to their specific demands. Furthermore, the ethical aspects of Sharia finance, such as the practice of sharing risks and the prohibition of interest, align closely with the core values of local businesses, hence enhancing the appeal of these financial services. Furthermore, the effectiveness of Sharia financing is greatly dependent on the financial acumen of entrepreneurs in relation to Islamic finance principles, underscoring the necessity for continuous education and advising services offered by banks. These case studies demonstrate the practical applications and advantages of Sharia financial services. They also emphasize the strategic significance of tailored financial solutions that accord with both economic objectives and religious beliefs.

### **Technological Advancements in Sharia Financial Services**

The integration of technology in Sharia financial services has significantly transformed how these services are delivered in Indonesia, overcoming traditional barriers and enhancing overall efficiency and accessibility. One of the standout examples of technological advancement is the adoption of mobile banking platforms by Islamic banks. These platforms cater specifically to the needs of MSMEs by providing instant access to financial services, including real-time payment processing and mobile-based loan applications, all within a framework that adheres to Sharia principles. For instance, BNI Syariah has implemented a mobile banking app that allows its users to conduct non-interest-based transactions seamlessly, promoting financial inclusion among those who might otherwise be excluded from the conventional banking system due to geographical or socio-economic barriers. Furthermore, the deployment of blockchain technology in Sharia financial services offers a groundbreaking development in ensuring transparency and security, critical elements in Islamic finance. Blockchain's immutable ledger and the ability to track transactions end-to-end align perfectly with the need for transparency in Sharia-compliant transactions, which forbid uncertain and speculative dealings. An example is the collaboration between BRI Syariah and local fintech startups to develop blockchain solutions that underpin the Sharia compliance of their financial products, ensuring that all contractual elements are met and visibly recorded, and that profit-sharing is executed according to agreed terms. These technological integrations not only streamline operations and reduce costs but also build trust with clients by aligning modern financial practices with traditional Islamic values. By leveraging technology, Sharia financial services are not only addressing the unique needs of the Indonesian market but also setting a benchmark for innovation in the global Islamic finance industry. This approach not only enhances service delivery but also positions Islamic banks as leaders in the adoption of cutting-edge technology tailored to ethical financial practices.

### **Challenges in Scaling and Adoption**

Scaling Sharia-compliant financial services for MSMEs in Indonesia faces significant obstacles that span cultural, economic, and educational domains, impeding broader adoption and integration into the mainstream financial ecosystem. Culturally, there is a profound need for a deeper understanding and acceptance of Sharia financial principles,

## Proceeding 2<sup>nd</sup> Medan International Economics and Business

Volume 2, Issue 1, 2024

“Human Resource Transformation and Collaborative Innovation to Build Independent and Competitive Business in the Digital Era”

which differ markedly from conventional practices. Many entrepreneurs, while interested in the ethical dimensions of Sharia finance, may lack comprehensive knowledge of its mechanisms and benefits, leading to hesitation in adopting these services. For example, some business owners are unaware that Sharia financing models such as Mudarabah (profit-sharing) do not require collateral, unlike many conventional loans, which could be particularly advantageous for startups and small enterprises with limited assets. Economically, the relatively higher operational costs associated with maintaining compliance with Sharia law can deter smaller banks from offering such services, thus limiting accessibility for MSMEs. Additionally, the limited number of Islamic finance experts and the higher cost of training staff in Sharia compliance further restrict the capacity of financial institutions to scale these services effectively. For instance, smaller regional banks in more remote areas of Indonesia might struggle to afford the specialist staff needed to oversee and implement compliant financial products. Educationally, there remains a significant gap in financial literacy concerning the specifics of Islamic finance. Many MSMEs are not fully aware of how Sharia-compliant products could benefit their businesses specifically. This gap is particularly evident in rural or less urbanized areas, where traditional banking services are sparse, and information about alternative financing models like Islamic finance is even scarcer. To address these challenges, there have been initiatives like seminars and workshops conducted by major Islamic banks, such as Mandiri Syariah, aimed at educating small business owners about the principles and advantages of Sharia finance. Overall, overcoming these cultural, economic, and educational barriers requires concerted efforts from multiple stakeholders, including financial institutions, government agencies, and educational organizations, to promote the advantages, increase the accessibility, and enhance the understanding of Sharia-compliant financial services among Indonesian MSMEs.

### CONCLUSION

To foster a more conducive environment for the growth of Sharia financial services in Indonesia, strategic recommendations for policymakers, financial institutions, and other stakeholders are essential. Policymakers should consider implementing regulatory reforms that simplify the licensing process for new Sharia-compliant products and create tax incentives for businesses utilizing Islamic financing. Such measures would not only make Sharia financial services more attractive to MSMEs but also enhance the sector's competitiveness. For example, the Indonesian government could look to models like Malaysia's Shariah-compliant SME financing scheme, which offers tax relief to banks providing Islamic financing to small businesses, encouraging more institutions to develop and offer Sharia-compliant products. Financial institutions, on the other hand, need to invest in targeted marketing and educational campaigns to build awareness and understanding of Sharia financial products. These institutions could partner with local community organizations and educational institutions to conduct workshops and seminars that demystify Islamic finance principles and showcase successful case studies of businesses that have thrived with Sharia-compliant financing. For instance, BRI Syariah has had success with community engagement initiatives that improve financial literacy and demonstrate the practical benefits of Sharia financing, helping to break down misconceptions and build trust.

## Proceeding 2<sup>nd</sup> Medan International Economics and Business

Volume 2, Issue 1, 2024

“Human Resource Transformation and Collaborative Innovation to Build Independent and Competitive Business in the Digital Era”

Additionally, stakeholders should collaborate to develop and deploy technology solutions that enhance the accessibility and efficiency of Sharia financial services. Leveraging fintech innovations, such as mobile banking apps and blockchain technology, can help Islamic financial institutions reach underserved areas, improving financial inclusion and allowing for broader economic participation of MSMEs. A prime example includes the use of blockchain by Bank Syariah Indonesia to streamline and secure payment processes, ensuring transparency and adherence to Islamic finance principles. By aligning efforts across these areas—regulatory reform, educational outreach, and technological innovation—policymakers, financial institutions, and other stakeholders can significantly enhance the ecosystem for sharia financial services. This will not only empower msmees but also stimulate broader economic development, ensuring that the benefits of islamic finance can be realized across indonesia’s diverse economic landscape.

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## Proceeding 2<sup>nd</sup> Medan International Economics and Business

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Volume 2, Issue 1, 2024

“Human Resource Transformation and Collaborative Innovation to Build Independent and Competitive Business in the Digital Era”

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