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TRANSFORMATION OF INDONESIAN ISLAMIC BANKING: OPPORTUNITIES, CHALLENGES, AND THE FUTURE

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Abstract

This study aims to analyze the transformation of Islamic banking in Indonesia by highlighting key strategic opportunities, major challenges, and future development directions. A descriptive qualitative approach is used, employing a literature review method based on secondary data such as official reports from the Financial Services Authority (OJK), Bank Indonesia, and recent academic publications. The study is grounded in organizational transformation theory, innovation theory, human capital theory, and institutional theory as its analytical framework. The findings reveal that the transformation of Islamic banking is driven by digitalization of financial services, increasing public awareness of Islamic economics, and strong regulatory support. However, the sector continues to face challenges such as limited innovative products, a shortage of competent human resources, and institutional structures that remain dependent on conventional parent banks. The study concludes that the success of Islamic banking transformation in Indonesia requires a holistic strategy encompassing institutional strengthening, human capital development rooted in Islamic values, and collaboration among financial institutions, the halal industry, and regulators. With such strategic efforts, Indonesia holds significant potential to become a global hub for Islamic finance.

Keywords: *Islamic banking, transformation, Islamic finance*

Abstrak

Penelitian ini bertujuan untuk menganalisis proses transformasi perbankan syariah di Indonesia dengan menyoroti peluang strategis, tantangan utama, dan arah pengembangan masa depan. Pendekatan yang digunakan adalah deskriptif kualitatif dengan teknik studi kepustakaan terhadap data sekunder, seperti laporan Otoritas Jasa Keuangan, Bank Indonesia, serta literatur ilmiah terkini. Penelitian ini didasarkan pada teori transformasi organisasi, teori inovasi, teori modal insani, dan teori kelembagaan sebagai kerangka analisis. Hasil kajian menunjukkan bahwa transformasi perbankan syariah didorong oleh digitalisasi layanan keuangan, meningkatnya literasi masyarakat terhadap ekonomi syariah, serta dukungan regulasi yang progresif. Namun demikian, sektor ini masih menghadapi tantangan berupa keterbatasan produk inovatif, kurangnya sumber daya manusia yang kompeten, dan struktur kelembagaan yang belum sepenuhnya mandiri. Penelitian ini menyimpulkan bahwa keberhasilan transformasi perbankan syariah Indonesia memerlukan strategi holistik yang mencakup penguatan kelembagaan, pengembangan sumber daya manusia berbasis nilai-nilai Islam, serta kolaborasi antara lembaga keuangan, industri halal, dan regulator. Dengan langkah strategis tersebut, Indonesia memiliki peluang besar untuk menjadi pusat keuangan syariah global.

Kata-kata kunci: Perbankan syariah, digitalisasi, keuangan syariah

INTRODUCTION

The The Islamic banking industry in Indonesia has shown significant growth in the last decade. As a country with the largest Muslim population in the world, more than 87% of the total population or around 230 million people, Indonesia has great potential to become a global Islamic financial center (Bank Indonesia, 2023). This verse is the main foundation in the Islamic financial system and is a fundamental reason for the need for transformation of the banking system to be in line with Islamic teachings. Therefore, strengthening Islamic financial institutions in Indonesia is not just a policy choice, but is part of the moral and spiritual mandate of Muslims to realize fair, ethical, and usury-free finance.

According to the Financial Services Authority (OJK, 2023), total Islamic banking assets by the end of 2023 reached more than IDR 850 trillion, with an annual growth of around 15–16%. However, the market share of Islamic banking is still relatively small compared to conventional banks, which is around 7.5% of the total assets of the national banking system. This growth is supported by increasing public awareness of the importance of Islamic economic principles in everyday life, as well as strengthening government regulations and policies. Law No. 21 of 2008 concerning Islamic Banking provides a clear legal framework for the development of this industry. In addition, strategic initiatives such as the National Islamic Economic and Financial Development Master Plan (2020–2024) launched by Bank Indonesia and OJK have strengthened the foundation of Islamic banking transformation (Bank Indonesia, 2023).

Firdaus and Putri (2024) emphasized that the development of the sharia ecosystem should adopt a holistic and collaborative approach to promote inclusivity, stability, and national economic growth. This underscores the importance of integrating sharia financial institutions, halal industry players, and social institutions such as zakat and waqf. However, amidst the increasingly open opportunities, Islamic banking also faces various challenges. Limited products that do not fully reflect Islamic values, lack of competent human resources, and market fragmentation due to the dominance of Islamic business units under conventional banks are crucial issues (Idris & Huda, 2023). On the other hand, banking digitalization opens up new opportunities for Islamic banks to reach the younger generation through Islamic fintech, mobile banking services, and digital banking platforms such as Allo Bank Syariah and Jenius Syariah (Nurwahidah, 2023).

According to the World Bank (2024), Indonesia has significant potential to become a global leader in Islamic economy and finance, provided that it can accelerate structural reforms and broaden access to Islamic financial services across all segments of society. This shows that although challenges still exist, the future prospects of Indonesian Islamic banking remain bright if supported by the right policies, continuous innovation, and increased human resource capacity.

Digitalization is one of the main drivers of the transformation of Islamic banking. The presence of Islamic fintech and the integration of mobile banking have expanded access to services to young and urban communities (Nurwahidah, 2023). In addition, Islamic financial literacy and inclusion have increased along with the educational campaigns promoted by the OJK and Bank Indonesia.

With the global trend towards ESG (Environmental, Social, and Governance) investments that are in line with sharia principles, Indonesia has the opportunity to position sharia banking as a sustainable financial alternative. Instruments such as retail sukuk, sharia crowdfunding, and sharia-based green financing are starting to gain ground in both domestic and international markets (World Bank, 2024).

In the future, the transformation of Islamic banking will not only depend on increasing institutional capacity, but also on the integration of the Islamic financial ecosystem as a whole. Collaboration between Islamic financial institutions, the halal industry, zakat institutions, and the government is key to realizing Indonesia's vision as the world's Islamic financial center (Firdaus & Putri, 2024).

This study aims to provide an in-depth overview of the transformation process of Islamic banking in Indonesia with a focus on opportunities, challenges, and future projections of the industry. Specifically, this study seeks to identify strategic opportunities that can be utilized to expand the reach of services and increase the growth of Islamic banking assets. In addition, an analysis is also conducted to understand the structural, operational, and regulatory barriers that have so far hampered the optimization of the performance of this sector. Furthermore, this study attempts to design a direction for the development of Indonesian Islamic banking that is more inclusive, innovative, and highly competitive in facing the demands of the national market and the dynamics of global Islamic finance.

LITERATUR REVIEW

Transformation

Literally, the word *transformation* comes from the Latin word "*transformatio*", which means change in form or structure. In the context of business and management, transformation refers to the process of fundamental change carried out by an organization to improve its efficiency, effectiveness, and competitiveness amidst the dynamics of the external and internal environment (Kotter, 1996). In this study, transformation refers to fundamental changes in the business model, operational systems, services, and management strategies of Islamic banking in Indonesia. This process can include digitalization of financial services, product innovation according to Islamic principles, restructuring of human resources, and adaptation to new regulations. The main objective of transformation is for Islamic banking institutions to remain relevant, competitive, and able to answer the needs of modern society without deviating from Islamic values.

A real example of transformation in Indonesian Islamic banking is the presence of digital Islamic banks such as Allo Bank Syariah and Jenius Syariah, which shows the industry's efforts to adapt to technological developments and the preferences of the younger generation.

Islamic Banking

Islamic banking is a banking system that operates based on Islamic sharia principles. Its main principles include the prohibition of *riba* (interest), *gharar* (excessive uncertainty), and *maisir* (gambling), as well as the application of the concepts of profit sharing, transparency, and social responsibility (Huda & Rahman, 2022). This system is not only aimed at seeking profit, but also maintaining a balance between economic and moral aspects. In Indonesia, Islamic banking is regulated in Law No. 21 of 2008 concerning Islamic Banking, which provides a legal framework for the establishment and operation of Islamic commercial banks and Islamic business units (UUS) under conventional banks. Currently, Islamic banking is one of the fastest growing financial sectors, although its market share is still relatively small compared to conventional banking.

In this study, Islamic banking is the main subject that is undergoing a transformation process in terms of services, management, and position in the national and global financial ecosystem.

Opportunity

In general, opportunities can be defined as conditions or situations that allow an institution or sector to develop, expand its reach, or achieve certain goals

(OECD, 2023). In the business world, opportunities often arise from changes in the macro environment such as technological developments, government policies, market demand, or socio-cultural dynamics. In the context of this study, opportunities refer to positive factors that support the growth and development of Islamic banking in Indonesia. Some of these opportunities include:

1. The world's largest Muslim population creates a huge domestic market potential.
2. Digitalization and development of sharia fintech that expands access to financial services.
3. Increasing public awareness of Islamic economic principles.
4. Support from government policies and monetary authorities such as OJK and Bank Indonesia.

Utilizing these opportunities is essential to accelerate Islamic financial inclusion and increase the competitiveness of this sector in the national and international financial ecosystem.

Challenge

Challenges are obstacles or constraints faced by an institution in achieving its goals or carrying out its activities optimally (Prasetyo & Rahayu, 2023). Challenges can be internal such as HR capacity, organizational structure, and service products, or external such as regulations, market competition, and public perception. In this study, challenges refer to issues that hinder the optimization of growth and development of Islamic banking in Indonesia. Some of the main challenges include:

1. Market fragmentation due to the dual banking system (the existence of UUS under conventional banks).
2. Limited product and service innovation that does not fully reflect sharia principles.
3. Lack of competent human resources in the field of Islamic economics and finance.
4. Regulatory dynamics are sometimes not in sync between theory and field practice.
5. Tight competition with conventional banks that have a larger operational scale.

Addressing these challenges requires a holistic, collaborative, and sustainable development strategy.

Future

Philosophically, the future refers to the condition or direction of development of an object in the long term, which is influenced by current trends and possible changes in the future (World Bank, 2023). In economic and financial studies, the future is often analyzed through data projections, alternative scenarios, and potential adaptation to global change.

In the context of this research, the future of Indonesian Islamic banking will be discussed within the framework of Indonesia's vision as a global Islamic financial center. Strategic steps that need to be taken include:

1. Development of an integrated sharia ecosystem between financial institutions, halal industry, zakat, waqf, and government.
2. Islamic financial innovations such as retail sukuk, Islamic crowdfunding, and green financing.
3. Strengthening human resource capacity through sharia-based education and training.
4. Formulation of consistent long-term policies that support the growth of this sector.

Realistic and strategic future projections will help Indonesia position itself as a leader in the world's Islamic economy and finance.

Theoretical basis

Organizational Transformation Theory – Kotter (1996)

This theory explains that organizational transformation involves fundamental changes in structure, culture, strategy, and business processes to improve efficiency and competitiveness. According to Kotter (1996), there are eight main steps in the transformation process, namely creating a sense of urgency, forming a strong leadership team, designing a vision and strategy, communicating the vision, empowering action based on the vision, creating short-term wins, maintaining momentum, and rooting new changes.

Used to analyze how the process of digital transformation, internal restructuring, and strategic adaptation occurs in Indonesian Islamic banking. This theory helps explain how Islamic banks can adapt to market demands and modern technology without deviating from Islamic principles.

Product Innovation Theory – Rogers (2003)

Rogers (2003) stated that product innovation includes the introduction of new goods or services that provide added value for consumers. The innovation diffusion process is also key to market acceptance of the product. According to

Rogers, there are five characteristics of innovation, namely relative advantage, compatibility, complexity, trialability and observability.

Suitable for evaluating how Islamic financial products such as retail sukuk, Islamic crowdfunding, and green financing are introduced and accepted by the community. This theory helps explain the level of adoption and public perception of Islamic service innovations.

Human Capital Theory – Gary Becker (1964)

Becker (1964) stated that investment in education, training, and workforce skills will increase organizational productivity and performance. Human capital is an intangible asset that is not recorded on the balance sheet but has a significant influence on institutional performance. This theory highlights the strategic role of human capital as a long-term investment that contributes to sustainable organizational competitiveness.

This theory is relevant when discussing human resource challenges in the Islamic banking industry, including the need for capacity building through training, formal education, and sharia-based certification. Developing competent and sharia-compliant human resources is essential to ensure that Islamic financial institutions can meet market demands and uphold ethical standards. Therefore, integrating human capital development into institutional strategy is crucial to support the growth and resilience of the Islamic banking sector.

Institutional Theory – DiMaggio & Powell (1983)

This theory explains that institutions are influenced by social norms, regulations, and external environmental pressures. There are three isomorphism mechanisms, namely coercive (external coercion), mimetic (imitation), and normative (professional agreement).

Suitable for analyzing how government regulations, religious norms, and market dynamics influence the development of Islamic banking in Indonesia. This theory helps explain how Islamic institutions adapt to the rules and expectations of society.

Triple Bottom Line Model – Elkington (1997)

This concept was put forward by Elkington (1997), who emphasized that sustainability is not only about profit, but also social and environmental responsibility. Known as the principle of "People, Planet, Profit", this model is the basis for the concept of sustainable development. It encourages organizations to balance economic goals with ethical considerations and long-term environmental stewardship.

This concept is relevant to examine the potential integration of ESG (Environmental, Social, Governance) principles in Islamic banking, as well as the development of Islamic green financing instruments. The alignment between ESG values and sharia principles provides a strong foundation for promoting responsible and ethical finance. This theory helps explain how Islamic banking can contribute to sustainable development goals by fostering inclusive growth, environmental preservation, and social justice.

Endogenous Economic Growth Theory – Romer (1986)

Paul Romer developed the endogenous growth theory which emphasizes the importance of technological innovation and knowledge as the main factors of economic growth. He stated that investment in research and development and learning through experience are the keys to sustainable growth. This theory shifts the focus from external factors to internal capabilities, highlighting how economies can drive growth from within through innovation and intellectual capital.

This theory is used to analyze how innovation and increasing human resource capacity can drive sustainable growth of the Islamic banking sector. It underscores the need for continuous learning, technology adoption, and institutional innovation to remain competitive in a rapidly evolving financial landscape. The theory helps explain the relationship between technological development and the growth of Islamic financial institutions, particularly in expanding financial inclusion and improving operational efficiency.

Diffusion of Innovation Theory – Rogers (1962)

This theory explains how, why, and how quickly innovations spread among groups of people. Rogers divides people into groups of early adopters, early majority, late majority, and laggards, based on the level of acceptance of innovation. The diffusion process is influenced by factors such as perceived benefits, ease of use, social influence, and communication channels.

This theory is suitable for analyzing the adoption of digital sharia services (mobile banking, fintech) by the Indonesian people, especially the younger generation and millennials. Understanding these adoption patterns can help Islamic financial institutions tailor their strategies to increase user engagement and trust. This theory helps explain consumer behavior patterns towards sharia financial innovations and can guide efforts to accelerate digital transformation in the Islamic finance sector.

RESEARCH METHOD

Types of Research

This study uses a qualitative descriptive approach to provide an in-depth understanding of the transformation of Islamic banking in Indonesia. This method allows researchers to analyze phenomena contextually and interpretively according to the reality of the field (Moleong, 2016). This approach is in line with Creswell's (2014) opinion that qualitative research aims to explore and understand the meaning derived from individual or group experiences of a social problem. Thus, this approach is considered the most appropriate to describe the dynamics and development of Islamic banking in the Indonesian social and economic context.

Data source

This study uses secondary data obtained from academic literature, Islamic bank financial reports, policy documents from OJK and Bank Indonesia, and related journal articles. The selection of data sources was carried out purposively, focusing on references from the last five years (Sugiyono, 2019). According to Johnston (2017), secondary data analysis provides an efficient and effective means of utilizing existing information to generate new insights, especially when primary data collection is constrained by time or access. This approach ensures that the analysis remains relevant and grounded in up-to-date, authoritative sources.

Data collection technique

Data collection was carried out using a literature study method, by reviewing official documents such as *the National Sharia Economic and Financial Masterplan (2020–2024)*, annual reports of Islamic banks, and accredited scientific journals (OJK, 2023; Bank Indonesia, 2020).

Data Analysis Techniques

Data were analyzed using content analysis method *and* narrative descriptive approach. The analysis process was carried out by classifying data into themes such as forms of transformation, opportunities, challenges, and future development directions. To ensure data validity, source triangulation was carried out by comparing findings from various official literature (Creswell, 2014). According to Creswell (2014), triangulation is a validity strategy in qualitative research that is used to check the accuracy of findings by combining various data sources, methods, theories, or researchers. This technique enhances the credibility and trustworthiness of the research by cross-verifying information from different perspectives.

RESULTS

The findings of this study reveal that the transformation of Islamic banking in Indonesia has progressed significantly in recent years. This transformation is not merely technological, but reflects a broader institutional effort to enhance financial inclusion in line with Islamic values. One of the key indicators of this transformation is the rapid growth in Islamic banking assets, which demonstrates increasing public trust in the Islamic financial system.

The transformation process focuses on three major areas. The first is the digitalization of banking services. Islamic banks have increasingly adopted digital technologies to expand service outreach, improve operational efficiency, and deliver a more user-friendly experience, particularly for the younger, tech-savvy generation. Digital services such as mobile banking, online account opening, and integration with fintech platforms have become essential strategies in strengthening competitiveness in the digital era.

The second focus is the integration of the Islamic financial ecosystem. Islamic banks are now forming closer partnerships with other sectors within the halal economy, such as zakat institutions, waqf organizations, halal-certified industries, and Islamic educational institutions. This ecosystem-based collaboration is intended to create a comprehensive Islamic financial system that supports real-sector development, social welfare, and ethical finance in a mutually reinforcing way.

The third area is the strengthening of global competitiveness. Several initiatives have been taken to align the operations of Islamic banks with international standards, such as the development of sharia-compliant green financing instruments, application of ESG (Environmental, Social, and Governance) principles, and cross-border cooperation. This shows that Indonesia is not only focusing on domestic development but is also aiming to play a significant role in the global Islamic finance landscape.

Despite this progress, the transformation process still faces several structural challenges. One of the main challenges is the dominance of Islamic business units (UUS) that operate under conventional parent banks. This structure limits the autonomy of Islamic banking divisions, especially in product development and strategic decision-making. Without full independence, it is difficult for these units to innovate and implement distinctive business models aligned with Islamic values.

Another critical issue is the shortage of qualified human resources with deep understanding of Islamic economics and modern banking practices. Although training and certification programs are increasingly available, the number of professionals who possess both technical competence and sharia-based ethical grounding remains insufficient to meet the demands of the growing industry.

Furthermore, product innovation in Islamic banking is still limited. Many products are merely modified versions of conventional instruments, adapted with Islamic contracts but lacking substantive innovation. This often results in lower public interest, especially among customers who seek financial solutions that are fundamentally based on Islamic economic principles, not just technical compliance.

From an institutional perspective, the ongoing transformation does not yet fully reflect the ideal Islamic economic model. Much of the change remains adaptive—responding to market and regulatory pressures—rather than transformative in a philosophical or ideological sense. A deeper commitment is needed to build a financial system that is independent, inclusive, and aligned with the objectives of maqashid sharia.

In conclusion, while quantitative indicators such as asset growth and customer acquisition show promising results, qualitative dimensions such as governance, product differentiation, and social impact still require substantial improvement. The true transformation of Islamic banking in Indonesia will be realized only when the system not only adopts modern tools but also upholds its ethical foundation and leads in creating a more just and sustainable financial future.

DISCUSSION

This transformation process is closely aligned with Kotter's (1996) organizational transformation theory, which asserts that institutional change must begin with a strong sense of urgency and be guided by a clear strategic vision. In the context of Indonesian Islamic banking, urgency arises from two main forces: rapidly evolving digital consumer behavior and increasing regulatory expectations. The combination of these pressures has pushed Islamic financial institutions to adapt both structurally and technologically.

Rogers' (2003) diffusion of innovation theory also sheds light on the dynamics of adopting digital sharia products. The rate of acceptance of innovations such as sharia crowdfunding and green sukuk depends on the perceived advantages, compatibility, and ease of use. These products remain in the early stages of adoption, necessitating enhanced consumer education and awareness efforts, particularly for younger and urban Muslim populations.

Moreover, Becker's (1964) human capital theory remains highly relevant, as institutional change cannot be sustained without adequate investment in human resource development. The transformation of Islamic banking demands professionals who not only possess technical banking skills but also understand the ideological and jurisprudential foundations of Islamic finance. This dual competency remains a key gap within the sector.

Empirical studies reinforce this finding. Arifin and Suryanto (2022) found that digital transformation significantly enhances the operational performance of Islamic banks, but its success is dependent on the availability of skilled personnel and leadership commitment. Similarly, Saputra and Febriyanti (2024) emphasize that post-pandemic Islamic banking requires a new cadre of human capital equipped with digital literacy and sharia compliance.

Externally, DiMaggio and Powell's (1983) institutional theory helps explain the isomorphic pressures Islamic banks face—normative (religious standards), mimetic (peer imitation), and coercive (regulatory requirements). These forces often lead to institutional convergence, where banks adopt similar structures and practices, sometimes at the cost of innovation. Nonetheless, such adaptation is necessary to maintain legitimacy in both religious and financial domains.

Research by Idris and Huda (2023) shows that structural dependency on conventional parent banks (through UUS) limits innovation and institutional autonomy, further affirming the importance of institutional transformation. This structural limitation often results in derivative business models that lack distinctive Islamic identity, especially in product design and service delivery.

The integration of sustainability frameworks also presents new opportunities. Elkington's (1997) triple bottom line concept aligns well with Islamic finance, offering a pathway to promote ethical and environmentally conscious financial practices. Huda and Rahman (2022) documented that instruments like green sukuk and sustainable Islamic bonds have the potential to address both economic and environmental goals, aligning with global ESG trends.

In the policy realm, Kurniawan and Lestari (2023) argue that financial inclusion across ASEAN can be significantly enhanced by Islamic banking if regulatory frameworks are harmonized and supported by regional cooperation. This supports the notion that transformation must not be limited to internal reforms but also involve external partnerships and regulatory alignment.

Another critical point is the need for ideological transformation in addition to structural and technological change. While digital banking platforms are expanding, many Islamic banks still lack a business model rooted in *maqashid* sharia. According to Firdaus and Putri (2024), building a holistic Islamic financial ecosystem-integrating banking, zakat, waqf, and halal industry-is essential for long-term resilience and justice-oriented growth.

Finally, the World Bank (2024) highlights that Indonesia has immense potential to lead the global Islamic finance sector, but achieving this vision requires accelerating institutional reforms, broadening access to Islamic financial services, and fostering innovation beyond the imitation of conventional models.

In summary, while theoretical frameworks provide a solid basis for understanding the transformation process, previous empirical research affirms that Indonesia's Islamic banking sector is undergoing a dynamic but uneven transformation. Achieving true systemic change will require coordinated efforts in digital innovation, regulatory reform, human capital development, and philosophical reorientation toward the ethical foundations of Islamic economics.

CONCLUSSION

Based on the study, it can be concluded that the transformation of Indonesian Islamic banking is taking place on a promising scale, especially in terms of digitalization and the expansion of the halal financial ecosystem. However, a number of fundamental challenges still hamper the pace of this transformation, including limited product innovation, human resource quality, and institutional structures that are not yet fully independent. Addressing these issues requires a comprehensive strategy that not only enhances technical capacity but also strengthens the ideological foundation of Islamic financial practices to ensure sustainable and meaningful progress.

Great opportunities are opening up along with increasing public awareness of the sharia economy, the global trend of sustainable finance, and regulatory support from the government and OJK. These factors provide a strong foundation for Islamic banking to expand its market share and develop innovative financial products that align with Islamic values. However, these opportunities will be wasted if not balanced by institutional courage to abandon derivative models from conventional systems. Islamic banks must be willing to create original, sharia-based business models that are not only compliant but also transformative in delivering ethical, inclusive, and sustainable financial solutions.

True transformation requires a holistic approach: from strengthening ideological roots, institutional restructuring, to accelerating community literacy. This means that reforms must address not only technological and regulatory aspects but also the ethical and philosophical foundations of Islamic finance. With the right strategy and synergy between stakeholders, Indonesian Islamic banking has a great opportunity to not only complement the national financial system, but also become the main driver of economic change based on Islamic values. Such transformation would position Islamic banking as a catalyst for inclusive growth, social justice, and long-term economic resilience.

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