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HOW CAN ISLAMIC BANKING THRIVE IN A DUAL BANKING SYSTEM?
Legal and Economic Perspectives

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ABSTRACT

This research aims to analyse the challenges and opportunities facing Islamic banking within Indonesia's dual banking system, and to formulate policy recommendations to enhance its competitiveness. Employing a normative legal research methodology, complemented by a comparative study of Malaysia and Saudi Arabia, this study examines the relevant legal and economic frameworks. The findings reveal that regulatory disparities between Islamic and conventional banking, coupled with insufficient financial literacy and suboptimal institutional support, constitute the primary obstacles. To address these challenges, this research advocates for the harmonisation of regulatory frameworks, the augmentation of financial literacy through targeted educational and socialisation initiatives, and the fortification of institutional support via synergistic collaborations among governmental bodies, financial institutions, and the wider community. This study contributes to a nuanced understanding of the dynamics governing Islamic banking within a dual banking system, offering practical solutions for its sustainable development and growth. By identifying and analysing the key factors influencing the performance of Islamic banking, this research provides valuable insights for policymakers and stakeholders seeking to promote a more inclusive and robust financial sector. Furthermore, the comparative analysis with Malaysia and Saudi Arabia offers a broader perspective on best practices and potential strategies for enhancing the competitiveness of Islamic banking in Indonesia.

***Keywords**: Islamic banking, dual banking system, Sharia principles, legal framework, economic development,*

ABSTRAK

Penelitian ini bertujuan untuk menganalisis tantangan dan peluang yang dihadapi perbankan syariah dalam sistem perbankan ganda di Indonesia, dan merumuskan rekomendasi kebijakan untuk meningkatkan daya saingnya. Dengan menggunakan metodologi penelitian hukum normatif, dilengkapi dengan studi komparatif di Malaysia dan Arab Saudi, penelitian ini mengkaji kerangka hukum dan ekonomi yang relevan. Temuan-temuan menunjukkan bahwa kesenjangan peraturan antara perbankan syariah dan konvensional, ditambah dengan literasi keuangan yang tidak memadai dan dukungan kelembagaan yang kurang optimal, merupakan hambatan utama. Untuk mengatasi tantangan-tantangan tersebut, penelitian ini mengadvokasi harmonisasi kerangka kerja regulasi, peningkatan literasi keuangan melalui inisiatif pendidikan dan sosialisasi yang tepat sasaran, dan penguatan dukungan kelembagaan melalui kolaborasi sinergis di antara badan-badan pemerintah, lembaga-lembaga keuangan, dan masyarakat yang lebih luas. Studi ini memberikan kontribusi terhadap pemahaman yang lebih mendalam mengenai dinamika yang mengatur perbankan syariah dalam sistem perbankan ganda, serta menawarkan solusi praktis untuk pengembangan dan pertumbuhan yang berkelanjutan. Dengan mengidentifikasi dan menganalisis faktor-faktor kunci yang mempengaruhi kinerja perbankan syariah, penelitian ini memberikan wawasan yang berharga bagi para pembuat kebijakan dan pemangku kepentingan yang ingin mempromosikan sektor keuangan yang lebih inklusif dan kuat. Selain itu, analisis komparatif dengan Malaysia dan Arab Saudi menawarkan perspektif yang lebih luas mengenai praktik-praktik terbaik dan strategi potensial untuk meningkatkan daya saing perbankan syariah di Indonesia.

Kata kunci: *Perbankan syariah, sistem perbankan ganda, prinsip-prinsip syariah, kerangka hukum, pembangunan ekonomi,*

A. INTRODUCTION

Islamic banking has emerged as a significant financial sector globally, offering an ethical alternative to conventional banking by adhering to Sharia principles (Iqbal & Mirakhor, 2013). The theoretical foundation of Islamic banking is rooted in the maqashid shariah framework, which emphasizes justice (*al-'adl*), transparency (*bayān*), and public welfare (*maslahah*) in financial transactions (Chapra, 2008). In contrast to conventional banking, which operates on an interest-based system (*riba*), Islamic banking promotes profit-and-loss sharing mechanisms (*mudarabah*, *musharakah*) as a means to achieve economic equity (El-Gamal, 2006). However, within a dual banking system, Islamic banks often face challenges in competing with conventional banks due to differences in regulatory structures, risk management practices, and consumer preferences (Kammer et al., 2015). These challenges are particularly evident in Indonesia, where Islamic banks hold only 7.08% of total banking assets, indicating structural limitations that hinder their growth (OJK, 2023).

However, Indonesia, despite being home to the world's largest Muslim population, has struggled to fully capitalise on the potential of its Islamic banking sector (Bank Indonesia, 2023). The dual banking system, which allows Islamic and conventional banks to operate concurrently, was introduced to accommodate financial diversity and enhance economic inclusivity (Antonio, 2020). Nevertheless, concerns persist regarding whether this system provides an equitable platform for the expansion of Islamic banking, given that conventional banking still dominates Indonesia's financial landscape (Otoritas Jasa Keuangan [OJK], 2023).

Statistical data from the Financial Services Authority of Indonesia (OJK) reveals that the market share of Islamic banking remains significantly lower than that of conventional banks. As of 2023, Islamic banks in Indonesia accounted for only 7.08% of total banking assets, while conventional banks controlled the remaining 92.92% (OJK, 2023). This disparity raises fundamental questions about the challenges Islamic banks face within the dual banking system and the extent to which existing legal and regulatory frameworks enable or hinder their growth. Comparative studies indicate that Malaysia, which adopted a similar dual banking model, has successfully expanded its Islamic banking sector to represent 30.6% of total banking assets (Bank Negara Malaysia, 2023), suggesting that Indonesia's approach may require further policy refinement.

The dual banking system in Indonesia has been widely discussed in academic and policy discourse. However, most existing studies have primarily focused on its theoretical framework or have provided generic evaluations of Islamic banking performance (Sjahdeini, 2019; Saefuddin, 2022). There remains a paucity of empirical research that systematically examines the legal, regulatory, and economic barriers that Islamic banks face within this system. Furthermore, there is limited analysis on whether Indonesia's regulatory policies are effectively fostering a level playing field for Islamic finance.

While previous research has explored Islamic banking's role in economic development (Hassan & Lewis, 2021), this study aims to bridge the gap by (1) assessing the extent to which legal frameworks support or constrain Islamic banking growth, (2) identifying key regulatory discrepancies between Islamic and conventional banking, and (3) evaluating whether current policies are aligned with best practices from other countries with successful dual banking systems.

This study employs a normative juridical approach to analyze the legal and regulatory framework governing Islamic banking in Indonesia. The legal analysis is based on primary sources, including Law No. 21 of 2008 on Islamic Banking, OJK regulations, Bank Indonesia directives, and fatwas issued by the National Sharia Council (DSN-MUI). Additionally, this study integrates an economic analysis using quantitative data from the Financial Services Authority (OJK), Bank Indonesia, and global Islamic finance reports. The economic analysis assesses market share trends, profitability ratios, and policy effectiveness in supporting Islamic banking within the dual banking system. By combining legal interpretation and economic indicators, this research offers a comprehensive evaluation of Indonesia's regulatory environment and its impact on Islamic banking growth. Unlike prior studies, which often treat legal and economic challenges separately, this research adopts a comprehensive, interdisciplinary approach to assess the structural limitations and growth potential of Islamic finance.

Furthermore, this study incorporates empirical data analysis, including recent statistics from OJK, Bank Indonesia, and global Islamic finance reports, offering a more data-driven evaluation of Indonesia's dual banking system. This study also conducts a comparative legal analysis of Indonesia's Islamic banking policies against those of Malaysia and Saudi Arabia, two countries with established Islamic financial ecosystems. The comparative analysis focuses on three key dimensions: (1) Regulatory Frameworks – Examining differences in legal structures, central banking policies, and supervisory mechanisms (e.g., Malaysia's dual banking regulations under Bank Negara Malaysia vs. Indonesia's OJK framework). (2) Market Share and Growth Strategies – Analyzing Islamic banking penetration rates, government support mechanisms, and strategic policy interventions (e.g., Saudi Arabia's Vision 2030 and its impact on Islamic finance).

By identifying regulatory and economic bottlenecks, this study proposes policy recommendations aimed at improving Indonesia's dual banking model to better support Islamic banking. The findings have significant implications for regulators, policymakers, and financial institutions seeking to strengthen Islamic banking's role in national economic development.

This study seeks to address the following research questions: First, What are the primary legal and regulatory challenges faced by Islamic banking within Indonesia's dual banking system? Second, How does the current regulatory framework impact the competitiveness of Islamic banks compared to conventional banks? Third What lessons can Indonesia learn from Malaysia and Saudi Arabia in enhancing the role of Islamic banking? And Forth What policy recommendations can be proposed to create a more supportive environment for Islamic banking growth?

The remainder of this paper is structured as follows: Section 2 reviews the existing literature on Islamic banking in a dual banking system, identifying key challenges and regulatory gaps. Section 3 outlines the research methodology, including data collection and analysis techniques. Section 4 presents the findings, focusing on regulatory barriers, economic constraints, and comparative insights from Malaysia and Saudi Arabia. Section 5 discusses policy implications and recommendations. Finally, Section 6 provides conclusions and future research directions

B. METHOD

This study adopts a legal normative research approach (doctrinal research) to critically examine the regulatory and economic framework governing Islamic banking within Indonesia's dual banking system. Doctrinal legal research is well-suited for analysing laws, regulations, judicial interpretations, and financial policies that shape the operation of Islamic banking (Hutchinson & Duncan, 2012). This research primarily focuses on identifying legal barriers and assessing whether the regulatory framework supports the sustainable development of Islamic finance. Furthermore, a comparative legal method is applied to benchmark Indonesia's regulatory approach against Malaysia and Saudi Arabia, two countries with well-established Islamic banking systems (El-Gamal, 2006).

The study relies on secondary data sources consisting of primary legal materials such as Indonesia's Banking Law No. 21 of 2008 on Islamic Banking, Bank Indonesia (BI) regulations, and Otoritas Jasa Keuangan (OJK) directives related to Islamic banking governance. Additionally, fatwas issued by the National Sharia Council (DSN-MUI) are examined to assess the extent to which Islamic financial practices align with national banking regulations. Secondary sources, including academic books, journal articles, and policy reports from Bank Indonesia, OJK, the Islamic Financial Services Board (IFSB), and Bank Negara Malaysia, provide further insight into the economic and regulatory challenges of the dual banking system.

To evaluate the effectiveness of Indonesia's regulatory framework, this study employs a comparative legal analysis (Zweigert & Kötz, 1998). The comparison is structured around three key areas: (1) regulatory frameworks, assessing how Indonesia's banking laws compare with those of Malaysia and Saudi Arabia; (2) institutional governance, analysing differences in the oversight mechanisms of OJK and DSN-MUI compared to Malaysia's Bank Negara and Saudi Arabia's financial regulators; and (3) market growth and economic impact, measuring the success of Islamic banking in different jurisdictions. A functional comparative approach is utilised to examine how specific legal mechanisms in Malaysia and Saudi Arabia have contributed to the rapid expansion of Islamic finance (Örücü, 2007).

The research follows a qualitative content analysis methodology to systematically review legal texts, regulations, policy reports, and financial data. Following the Miles and Huberman (1994) model, the analysis is conducted in four stages: (1) Data Collection, gathering legislative and financial documents from Indonesia and comparator countries; (2) Data Reduction, categorising regulatory and economic factors affecting Islamic banking growth; (3) Data Display, presenting findings through comparative legal tables and structured discussions; and (4) Conclusion Drawing, formulating recommendations for strengthening Indonesia's dual banking system.

This study integrates empirical financial data from OJK, Bank Indonesia, and the Islamic Financial Services Board (IFSB) to substantiate findings regarding Islamic banking's performance. As of 2023, Islamic banking assets in Indonesia account for only 7.08% of the total banking sector, compared to 30.6% in Malaysia and 51.8% in Saudi Arabia (OJK, 2023; Bank Negara Malaysia, 2023). These figures highlight the disparity in Islamic banking development, reinforcing the need for a regulatory reassessment to enhance Islamic finance competitiveness.

By combining legal doctrinal analysis, comparative law research, and empirical financial assessment, this study provides a comprehensive evaluation of Indonesia's dual banking system. The findings will contribute to legal scholarship and offer policy recommendations for regulators and financial institutions seeking to create a more enabling environment for Islamic banking. The methodological approach ensures a rigorous, interdisciplinary analysis that integrates legal, economic, and financial dimensions to enhance the sustainability of Islamic banking in Indonesia.

C. RESULT AND DISCUSSION

1. Current State of Islamic Banking in Indonesia

Indonesia, as the country with the largest Muslim population, holds significant potential for the expansion of Islamic banking. However, despite steady growth, the Islamic banking sector remains a minor player within the national banking industry. As of October 2024, Islamic banks accounted for only 8% of total banking assets, a slight increase from 7.44% in 2023 (Statista, 2024). This figure reflects both the progress made and the challenges that persist in positioning Islamic banking as a mainstream financial alternative.

The Financial Services Authority of Indonesia (Otoritas Jasa Keuangan [OJK], 2024) reported that the total assets of Islamic banks reached IDR 658.96 trillion, marking a 12.50% year-on-year increase, compared to a 10.19% growth rate in 2023. This trend signals an expanding market, yet it still lags behind the conventional banking sector, which continues to dominate financial services in Indonesia. The following table illustrates the key financial indicators of Islamic banking in Indonesia over the past three years:

Table 1. Growth of Islamic Banking in Indonesia (2022–2024)

Year	Total Assets (IDR Trillion)	Asset Growth (%)	Market Share (%)
2022	531.86	-	6.51
2023	586.06	10.19	7.44
2024	658.96	12.50	8.00

(Source: OJK, 2024)

From an empirical perspective, the growth of Islamic banking is promising but still disproportionate to the potential market size. Indonesia's Muslim-majority population exceeds 230 million people, yet the penetration of Islamic banking remains limited (Statista, 2023). This raises critical questions regarding the effectiveness of regulatory policies, financial literacy, and public trust in Islamic financial institutions.

The dual banking system in Indonesia allows Islamic and conventional banks to operate concurrently, creating both opportunities and constraints. According to Hassan and Lewis (2022), dual banking models have the advantage of providing customers with financial diversity, enabling them to choose between conventional and Sharia-compliant products. However, in practice, Islamic banks often face structural disadvantages, such as higher operational costs due to compliance with Sharia principles and limited product innovation compared to their conventional counterparts.

Empirical research on Malaysia’s Islamic banking sector provides insights into potential strategies for Indonesia. Malaysia's Islamic banking industry holds a 30.6% market share, significantly higher than Indonesia’s 8% (Bank Negara Malaysia, 2024). The Malaysian government’s proactive regulatory framework, including tax incentives for Islamic financial products and stringent Sharia governance mechanisms, has facilitated the rapid development of its Islamic banking sector (Rahman et al., 2023). This suggests that Indonesia could benefit from a more supportive regulatory environment that incentivises the adoption of Islamic financial services.

Several structural barriers impede the full realisation of Islamic banking's potential in Indonesia. Firstly, limited public awareness and misconceptions about Islamic banking products remain widespread. A survey conducted by OJK (2023) found that only 40% of Indonesians fully understand the fundamental differences between Islamic and conventional banking. This knowledge gap directly impacts financial inclusion, limiting the adoption of Sharia-compliant financial products.

To address this, a multi-stakeholder approach is required, involving regulators, educational institutions, and financial service providers. Regulators such as OJK and Bank Indonesia should collaborate with universities and Islamic finance organizations to integrate Islamic finance into mainstream financial education curricula. Additionally, Malaysia's model of public awareness campaigns, which includes media outreach programs and partnerships with religious institutions, has successfully increased public engagement with Islamic banking services (Rahman et al., 2023). Implementing similar initiatives in Indonesia could significantly boost Islamic banking penetration rates

Secondly, regulatory disparities create additional challenges. While conventional banks have access to a broader range of financial instruments and investment channels, Islamic banks face restrictions on speculative investments, interest-based transactions, and financial derivatives (Iqbal & Mirakhor, 2021). While these restrictions align with Sharia principles, they also limit the flexibility of Islamic banks in responding to market demand.

From an economic perspective, Islamic banks also exhibit lower profitability margins than their conventional counterparts due to the prohibition of interest-based lending (riba). However, a major contributing factor to this discrepancy is the regulatory framework itself. In Indonesia, Islamic banks face stricter capital requirements, limitations on permissible investment instruments, and additional Sharia compliance costs, while conventional banks benefit from more flexible financial instruments and government-backed liquidity support. In contrast, Malaysia's regulatory framework offers tax incentives and policy support for Islamic financial institutions, allowing them to maintain competitiveness against conventional banks (Bank Negara Malaysia, 2024). If Indonesia does not implement similar measures, the disparity in market share between Islamic and conventional banks is likely to persist. This limitation underscores the need for financial product innovation to enhance market competitiveness.

Comparing Indonesia's Islamic banking sector with countries that have successfully integrated Islamic finance into their economies provides valuable insights. Saudi Arabia and the United Arab Emirates (UAE), for instance, have Islamic banking sectors that account for over 50% of total banking assets (The Banker, 2024). The success of Islamic banking in these regions can be attributed to strong government support, rigorous Sharia compliance frameworks, and public confidence in Islamic finance (Ahmed, 2023).

A key lesson for Indonesia from these case studies is the importance of integrating Islamic finance into national economic development plans. Countries with high Islamic banking penetration tend to have government-backed initiatives that promote financial literacy, digital banking solutions, and industry-academia collaborations (Hasan, 2022). Indonesia's regulators should consider expanding incentives for Sharia-compliant financial instruments and strengthening consumer education efforts to boost market penetration.

Despite the positive growth trajectory of Islamic banking in Indonesia, substantial structural reforms are necessary to prevent market stagnation and ensure long-term sustainability. The absence of regulatory alignment between Islamic and conventional banking creates an uneven playing field, limiting the expansion of Sharia-compliant financial products. Without comprehensive regulatory reforms, Islamic banks will continue to face higher operational costs, reduced investor confidence, and slower financial inclusion rates. Additionally, the lack of standardized governance frameworks may discourage international investors from engaging with Indonesia's Islamic banking sector, further hindering its global competitiveness.. Three key areas require urgent attention:

a. Regulatory Reforms: The government must establish a level playing field between Islamic and conventional banks by offering tax incentives for Sharia-compliant products, reducing bureaucratic hurdles for Islamic financial institutions, and allowing greater flexibility in investment instruments.
b. Public Awareness Campaigns: Given the low financial literacy rates regarding Islamic finance, nationwide educational initiatives must be launched to increase consumer confidence in Sharia-compliant banking.
c. Product Diversification and Innovation: Islamic banks must expand their financial product offerings beyond traditional mudharabah and musyarakah contracts to include Sharia-compliant microfinance solutions, fintech integration, and green sukuk (Islamic bonds).

Without these interventions, Islamic banking in Indonesia may continue to grow at a slower rate than its actual market potential, limiting its contribution to the broader financial sector.

2. Comparative Analysis with Malaysia

Malaysia serves as a benchmark in the Islamic banking sector, exhibiting a more substantial integration of Sharia-compliant financial services within its economy compared to Indonesia. As of 2021, Islamic banking assets in Malaysia constituted approximately 31.5% of the total banking assets, significantly higher than Indonesia's 6.1% during the same period (Islamic Financial Services Board [IFSB], 2022). This disparity underscores the effectiveness of Malaysia's regulatory frameworks and market strategies in promoting Islamic finance.

A study by Sufian (2007) analysed the efficiency of the Islamic banking sector in Malaysia and found that Malaysian Islamic banks exhibited higher efficiency levels compared to their counterparts in other regions. This superior performance is attributed to Malaysia's comprehensive Islamic banking infrastructure and supportive regulatory environment. Similarly, Bader, Mohamad, Ariff, and Hassan (2008) compared the efficiency of Islamic and conventional banks in Malaysia and found that Islamic banks operated with comparable efficiency levels to conventional banks. Their findings indicated that Malaysian Islamic banks maintained higher efficiency levels, primarily due to economies of scale and advanced technological adoption. Moreover, research by Wardana and Abdani (2023) identified Return on Assets (ROA) and Non-Performing Financing (NPF) as significant factors affecting the efficiency of Islamic banks in both Indonesia and Malaysia, whereas bank size was found to have no substantial impact. This suggests that Indonesian Islamic banks could enhance their efficiency by improving scale operations and leveraging technology (Wardana & Abdani, 2023).

Furthermore, empirical studies indicate that Islamic banks in Malaysia demonstrate a higher average efficiency rate than their Indonesian counterparts. Over the period from 2019 to 2022, the average efficiency for Malaysian Islamic banks was approximately 98.5%, compared to 92.25% for Indonesian Islamic banks (Ascarya, A., & Yumanita, D. (2008).). However, other studies have contested this, suggesting that Indonesian Islamic banks may exhibit marginally higher efficiency, although the difference remains statistically insignificant (Rani, et al, 2017). This suggests that while Malaysia's regulatory and infrastructural advantages provide an efficiency boost, Indonesia's Islamic banks have demonstrated resilience and competitive efficiency. Moreover, Rosman, Wahab, and Zainol (2014) examined the efficiency of Islamic banks during financial crises and concluded that while Malaysian Islamic banks maintained their efficiency, they often faced higher operational costs due to compliance requirements.

The following table provides a comparative overview of key financial indicators between Islamic and conventional banks in Malaysia:

Table 2. comparate between Islamic and conventional banks in Malaysia

Indicator	**Islamic Banks**	**Conventional Banks**
Return on Assets (ROA)	0.9%	1.2%
Return on Equity (ROE)	10.5%	12.8%
Cost-to-Income Ratio	50.2%	45.6%
Non-Performing Loan Ratio	1.3%	1.8%

Source: Islamic Financial Services Board (2022)

The data illustrates that while Islamic banks in Malaysia demonstrate commendable asset quality, as evidenced by a lower non-performing loan ratio, they lag behind conventional banks in terms of profitability metrics such as ROA and ROE. This suggests that despite a supportive regulatory environment, Islamic banks face inherent challenges in achieving profitability levels comparable to conventional banks. Empirical evidence suggests that higher operational costs due to stringent Sharia compliance requirements impact the competitiveness of Islamic banks (Rosman et al., 2014). In addition, research conducted by Chowdhury & Haron, (2021) further confirms that compliance costs are a major contributor to Islamic banks' lower profitability, as they necessitate rigorous financial structuring to align with Sharia principles.

Theoretically, the dual banking system in Malaysia, which allows Islamic and conventional banks to operate simultaneously, offers consumers a choice between Sharia-compliant and interest-based financial products. This system promotes financial inclusion and caters to diverse customer preferences. However, while Malaysia's model provides significant market flexibility, empirical studies highlight that Indonesian Islamic banks have maintained competitive efficiency despite a lower market share (Rani, et al, 2017). This resilience is attributed to strategic cost management and regulatory adaptations that mitigate the challenges faced by the sector.

In my opinion, Indonesia can draw valuable lessons from Malaysia's experience in integrating Islamic finance into its national economy. By strengthening regulatory frameworks, enhancing public awareness, and investing in technological advancements, Indonesia can improve the performance and market share of its Islamic banking sector. Additionally, fostering innovation in Sharia-compliant financial products could attract a broader customer base and enhance competitiveness with conventional banks.

In conclusion, while Malaysia's Islamic banking sector outperforms Indonesia's in terms of market share and efficiency, both countries face challenges in profitability and operational efficiency compared to conventional banks. Strategic initiatives focusing on regulatory support, technological adoption, and product innovation are essential for the sustained growth and competitiveness of Islamic banking in both nations. the sustained growth and competitiveness of Islamic banking in both nations.

3. Challenges within Indonesia's Dual Banking System

Indonesia's dual banking system, which allows Islamic and conventional banks to operate concurrently, presents unique challenges that impede the growth of Islamic banking. Despite the country's substantial Muslim population, Islamic banking assets accounted for only 6.51% of the total banking assets as of December 2022 (Otoritas Jasa Keuangan [OJK], 2023). This modest market share highlights the hurdles Islamic banks face within the dual banking framework.

A significant challenge is the regulatory environment, which often favours conventional banking practices. Islamic banks are subject to stringent Sharia compliance requirements, necessitating additional oversight and limiting the range of permissible financial instruments (Hassan et al., 2013). This regulatory disparity can result in higher operational costs and reduced competitiveness for Islamic banks.

Furthermore, public awareness and understanding of Islamic banking principles remain limited. A survey by the Financial Services Authority indicated that a considerable portion of the Indonesian population lacks adequate knowledge of Sharia-compliant financial products, leading to lower customer acquisition and retention rates (OJK, 2023).

The profitability of Islamic banks also poses a challenge. Data from 2022 reveals that the Return on Assets (ROA) for Islamic banks was 1.2%, compared to 2.0% for conventional banks (OJK, 2023). This disparity is partly due to the prohibition of interest (riba) in Islamic finance, which limits income-generating activities and affects profitability (Beck et al., 2013).

The following table illustrates key financial indicators comparing Islamic and conventional banks in Indonesia:

Table 3. comparing Islamic and conventional banks in Indonesia

Indicator	Islamic Banks	Conventional Banks
Return on Assets (ROA)	1.2%	2.0%
Return on Equity (ROE)	10.5%	15.3%
Non-Performing Financing Ratio	3.5%	2.1%

Source: OJK, 2023

The data indicates that Islamic banks have higher Non-Performing Financing Ratios, suggesting greater credit risk compared to conventional banks. This elevated risk may deter potential investors and customers, further hindering the growth of Islamic banking.

Theoretically, the dual banking system aims to provide consumers with a choice between conventional and Sharia-compliant financial services, promoting financial inclusion (Khan & Bhatti, 2008). However, the empirical challenges outlined above suggest that without a level playing field, Islamic banks may continue to struggle within this system.

In my opinion, addressing these challenges requires comprehensive regulatory reforms to ensure parity between Islamic and conventional banks. Additionally, enhancing public education on Islamic finance principles and developing innovative Sharia-compliant financial products could improve the competitiveness and appeal of Islamic banking in Indonesia.

4. Potential Strategies for Enhancing Islamic Banking Implementation

To bolster the implementation of Islamic banking in Indonesia, a multifaceted approach addressing regulatory frameworks, public awareness, technological integration, and product innovation is essential.

a. Regulatory Reforms

Establishing a robust regulatory environment is crucial for the growth of Islamic banking. The Indonesian government should consider implementing policies that create a level playing field between Islamic and conventional banks. This includes offering tax incentives for Sharia-compliant products and simplifying the approval process for new Islamic financial instruments. A study by Beck et al. (2013) highlights that supportive regulatory frameworks significantly contribute to the stability and efficiency of Islamic banks. Additionally, the establishment of a centralized Sharia Supervisory Board can ensure uniformity in Sharia compliance, thereby enhancing investor confidence.

b. Public Awareness and Education

Enhancing public understanding of Islamic banking principles is vital for increasing market penetration. Educational campaigns and financial literacy programs can demystify Sharia-compliant financial products, making them more accessible to the general populace. Empirical evidence suggests that higher financial literacy correlates with increased adoption of

Islamic banking services (Abdullah & Anderson, 2015). Collaborations between financial institutions, educational bodies, and religious organizations can facilitate widespread dissemination of information.

c. Technological Integration

Leveraging technology can significantly improve the efficiency and reach of Islamic banking services. The adoption of fintech solutions, such as mobile banking applications and blockchain technology, can streamline operations and attract a younger, tech-savvy customer base. A report by the Islamic Financial Services Board (2020) indicates that technological innovation is a key driver in the expansion of Islamic finance. Investing in cybersecurity measures is also essential to protect customer data and maintain trust.

d. Product Diversification and Innovation

Developing a diverse range of Sharia-compliant financial products can cater to varying customer needs and enhance competitiveness with conventional banks. This includes offering Islamic microfinance, sukuk (Islamic bonds), and takaful (Islamic insurance) products. A study by Ahmed (2010) found that product innovation in Islamic finance leads to increased market share and customer satisfaction. Furthermore, tailoring products to specific sectors, such as agriculture or small and medium-sized enterprises (SMEs), can promote inclusive economic growth.

Recent data underscores the potential for growth in Indonesia's Islamic banking sector. As of 2024, Islamic banking assets constituted approximately 8% of the total banking assets in Indonesia, up from 6.51% in 2022 (Otoritas Jasa Keuangan, 2024). Despite this growth, there remains substantial room for expansion. The following table illustrates the trend in Islamic banking assets over recent years (see Tabel 1)

The data indicates a positive trajectory, yet Islamic banking still represents a small fraction of Indonesia's financial sector. Implementing the strategies outlined above could accelerate this growth and enhance the sector's contribution to the national economy.

Theoretically, the principles of Islamic finance, such as risk-sharing and ethical investment, align with sustainable economic development (Chapra, 2008). Empirical studies have shown that Islamic banks can be as efficient and stable as conventional banks when supported by appropriate regulatory frameworks and innovative practices (Beck et al., 2013). Therefore, adopting a comprehensive strategy that encompasses regulatory reform, education, technology, and product innovation is likely to yield positive outcomes for Indonesia's Islamic banking sector.

In my view, the successful enhancement of Islamic banking in Indonesia hinges on a collaborative effort among regulators, financial institutions, and the public. Regulators must provide a conducive environment through supportive policies, while financial institutions should focus on innovation and customer education. The public, in turn, should be open to adopting Sharia-compliant financial products as viable alternatives to conventional banking services.

D. CONCLUSION

The findings of this study highlight the potential of Islamic banking within Indonesia’s dual banking system while also revealing significant structural and regulatory challenges that hinder its full development. Although Islamic banking assets have grown from 6.51% in 2022 to 8.00% in 2024, this increase remains relatively small compared to the dominance of conventional banks. Without meaningful policy reforms, Islamic banking will continue to face barriers to competitiveness, limiting its role in the national financial system.

From an academic perspective, this study contributes to the discourse on Islamic banking regulation, financial stability, and market efficiency. The research provides a comparative analysis with Malaysia, offering insights into best regulatory practices that Indonesia could adopt. The study aligns with the institutional theory of financial development, which emphasises that a well-regulated and inclusive financial system fosters economic growth and stability. Additionally, it supports the Sharia governance framework, stressing the necessity for regulatory oversight to ensure compliance while maintaining market competitiveness.

To strengthen Indonesia's Islamic banking sector, a multi-pronged policy strategy is required: 1. Legal and Regulatory Reform: The government should introduce a revised Banking Law that provides equal regulatory treatment for Islamic and conventional banks. This includes tax incentives for Sharia-compliant financial products, reduced capital adequacy requirements, and expanded investment options for Islamic banks. 2. Financial Literacy Enhancement: OJK and Bank Indonesia should mandate Islamic finance education in secondary schools and universities, in collaboration with the Ministry of Education and Islamic financial institutions. 3. Digital and Fintech Integration: The government should incentivize Islamic banks to adopt digital banking solutions and fintech partnerships, following Saudi Arabia's model of blockchain-based smart contracts for Sharia-compliant lending. These policy interventions should be implemented in a phased approach over five years, with clear performance metrics to assess their impact on Islamic banking growth..

For regulators, this study underscores the need for greater regulatory harmonisation between OJK, Bank Indonesia, and the National Sharia Board to streamline Sharia compliance and encourage sustainable growth. For academics, the research provides a foundation for future studies on Islamic banking resilience, digital finance in Sharia banking, and macroeconomic policy effects on Islamic finance growth. For banking practitioners, digital transformation, customer-centric financial products, and increased financial inclusion are critical to making Islamic banking a competitive alternative within the dual banking system.

Without proactive regulatory and industry-led interventions, Islamic banking in Indonesia risks remaining a niche segment within a conventional-dominated system. Lessons from Malaysia show that policy coordination, market-driven innovations, and strong regulatory support are the key pillars of a thriving Islamic banking industry. By implementing the proposed strategies, Indonesia can position itself as a global leader in Islamic finance, promoting a more inclusive, stable, and competitive dual banking system.

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